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Soviet International Finance in the Gorbachev Era

C. R. Neu

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PREFACE

This report was originally intended as a simple portrait of Soviet international financial practice: what kinds of international financial transactions the Soviet Union undertakes and who the counterparties to these transactions are. Since work began on this report in late 1989, though, the international financial circumstances of the Soviet Union have changed in important ways. In particular, the Soviet Union has gone from a first-class borrower, able to get the finest of terms in international credit markets, to what markets now perceive as a serious credit risk, able to borrow only with guarantees from Western governments. In addition to providing a profile of Soviet international financial activity, this report has necessarily also become a short history of the Soviet Union's reversal of financial fortunes.

This report updates material found in an earlier RAND report on Soviet international finance.[1] It also provides considerable new material necessitated by changes in the way the Soviet Union carries on its financial affairs. When necessary, material from the earlier report is repeated in this report, so that this report will stand alone. Like the earlier report, this report is based entirely on unclassified sources of information.

This work was undertaken in RAND's International Economic Policy Program and was sponsored by the Under Secretary of Defense for Policy under the auspices of RAND's National Defense Research Institute, a federally funded research and development center sponsored by the Office of the Secretary of Defense and the Joint Staff.

[1]C. R. Neu and John R. Lund, *Toward a Profile of Soviet Behavior in International Financial Markets*, RAND, R-3524-USDP, August 1987.

SUMMARY

Perestroika has brought important changes in the institutions, the instruments, and the purposes of Soviet international finance. With the elimination of the Ministry of Foreign Trade's monopoly on foreign trade transactions, other ministries, foreign trade organizations, enterprises, and republican governments have for the first time engaged directly in international commercial transactions and for the first time also have incurred international financial obligations. Soviet financial authorities have experimented with new forms of debt finance: international bond issues, floating-rate notes, nontraditional syndication arrangements for bank loans, and unprecedented (at least for the Soviet Union) collateral arrangements for loans. The previously spotless international payment record of the Soviet Union has been blemished as payments for imports have fallen into arrears. The first halting steps toward ruble convertibility have been taken. To meet growing demands for consumer goods, the Soviet Union expanded its international borrowing to what might have seemed impossible levels just a few years ago. Most important, though, and most ominously, within a period of less than a year—from the fall of 1989 to the summer of 1990—the Soviet Union was transformed from a preferred borrower in international credit markets, able to command the most attractive terms in its foreign borrowing, to a potentially serious international credit risk, almost completely without access to international credit markets on normal commercial terms and able to raise hard-currency funds only with the assistance of Western governments.

THE SOVIET HARD-CURRENCY BALANCE SHEET

Since the beginning of the Gorbachev era, there has been a debate within Soviet policy circles over how much and for what purposes the Soviet Union should depend on foreign borrowing. In the early years of this era, Soviet borrowing from foreigners was minimal. In the three and a half years from mid-1985 through the end of 1988, net Soviet hard-currency borrowing amounted to only $800 million. In the face of growing dissatisfaction over consumer goods shortages and spreading labor unrest, though, the Soviet government embarked in 1989 on a crash program of imports, financed largely by foreign borrowing. Net Soviet hard-currency borrowing in 1989 alone probably

reached $10 billion. By the end of 1990, the gross hard-currency debt of the Soviet Union was some $55 billion. Soviet net debt (gross debt minus hard-currency deposits in Western banks) was about $46 billion.

During the first quarter of 1990, both net and gross debts continued to expand rapidly. In the second quarter, though, Western banks—worried by Soviet payment arrearages and by the increasingly unsettled domestic political situation in the Soviet Union—began to reduce their exposure to the Soviet Union. This was done primarily by refusing to renew maturing loans. During the second quarter of 1990 alone, Western banks reduced their total loans outstanding to the Soviet Union by $4.6 billion. Unable to replace more than a fraction of this amount with credit from other sources, the Soviet Union was forced to draw down its hard-currency deposits in Western banks by $3.6 billion. For practical purposes, Soviet access to international credit on normal commercial terms had ended.

SOVIET DEALINGS WITH WESTERN BANKS

Borrowings from and deposits in Western commercial banks dominate the Soviet hard-currency balance sheet. At the end of 1990, debts to Western commercial banks accounted for about three-quarters of Soviet total gross debts, and deposits in Western banks accounted for virtually all of Soviet hard-currency assets.

Through the fall of 1989, the Soviet Union enjoyed good and generally improving terms in its borrowing from Western banks. From 1985 through 1989 the Soviet Union was routinely able to negotiate seven- and eight-year syndicated loans at spreads of only 25 basis points above the six-month London interbank offer rate (LIBOR). On a number of occasions, spreads of as little as one-eighth of a percentage point were arranged. Other countries that enjoyed similarly favorable terms during the late 1980s were Portugal, Thailand, Belgium, and Canada.

Until 1989, all foreign borrowing by the Soviet Union was undertaken by the Bank for Foreign Economic Activities of the Soviet Union (Vneshekonombank or VEB). Although VEB borrowing did not carry an explicit guarantee from the Soviet government, Western bankers assumed that the government would not allow the principal institution of Soviet international finance to fail in any of its obligations, and so extended credit to VEB on very fine terms. When other Soviet "names"—typically foreign trade organizations and republican

governments—appeared in international credit markets in 1989, they received much less favorable terms than VEB. Western bank confidence in the Soviet Union evaporated so quickly in early 1990 that there was no observable deterioration in the terms of Soviet credit. The Soviet Union went directly from being able to attract the most favorable terms to not being able to borrow at all.

In retrospect, it is possible to see that bank confidence had begun to erode as early as the latter part of 1988. In the fall of that year, new patterns of bank lending to the Soviet Union appeared. Previously, it was typical for banks from many nations to participate in syndications for loans to the Soviet Union. Beginning in October 1988, though, a number of very large loans were negotiated with purely national syndications—that is, all participating banks were from a single Western country. Western governments played important roles in arranging these syndications, and usually the loans were to finance exports from the lending country. At the time, a number of Western governments were intent on providing material support for the processes of economic and political reform perceived to be under way in the Soviet Union. By intervening with banks on behalf of the Soviet Union—either directly through loan guarantees or through less formal encouragement of bank lending—these governments probably helped the Soviet Union to achieve better terms from the banks than it could have gotten on its own. By mid-1990, bank confidence had declined sufficiently that banks would lend to the Soviet Union only with explicit guarantees from Western governments.

Despite past Soviet ability to negotiate medium-term syndicated credits on favorable terms, a large share of Soviet debt to Western banks is of very short maturity. (Much of this short-term debt reflects trade financing.) In the middle of 1990, 42 percent (about $17 billion) of all Soviet debt to Western banks was due to mature within twelve months. Because so much of its debt carries short maturities, the Soviet Union must be constantly in international credit markets attempting to roll over maturing debt, and even temporary losses of confidence can bring major contractions in available bank credit.

Before the collapse of lending to the Soviet Union on commercial terms, banks in a few Western countries accounted for most lending to the Soviet Union. At the end of 1989, banks in the United Kingdom accounted for a quarter of all bank claims on the Soviet Union. German and French banks accounted for another 28 percent. U.S. banks played a very small role, accounting for only 2.6 percent. No figures on the overall share of Japanese banks are available, but there

are indications that Japanese banks have been major, but low-profile, lenders to the Soviet Union. In the next year or so, the importance of German banks in lending to the Soviet Union will almost certainly increase as some very large lines of credit guaranteed by the German government and negotiated in 1990 are drawn upon.

Despite legislation making it legal for other Soviet entities to maintain hard-currency accounts abroad, all Soviet deposits in Western banks seem still to be held by VEB. Until 1990, these deposits were quite large in relation to the total volume of Soviet international trade transactions. They were also (and remain) of very short maturity. This is somewhat puzzling because short-maturity deposits earn relatively low rates of interest. By drawing down these deposits to repay outstanding loans, the Soviet Union could have reduced its net foreign interest payments. It appears that Soviet financial managers viewed these deposits as a hedge against temporary losses of access to hard-currency credit.

SOVIET DEBT TO OFFICIAL EXPORT CREDIT AGENCIES

After commercial banks, official export credit agencies of Western countries have been the most important source of hard-currency credit to the Soviet Union. Outstanding Soviet debt to these agencies, though, has been declining since the early 1980s. By the end of 1982, Soviet debt to the export credit agencies of the Organization for Economic Cooperation and Development (OECD) countries stood at $12 billion. At the end of 1989, it was only about $5 billion. The principal reason for this decline seems to have been that for much of the 1980s the Soviet Union was able to borrow on more attractive terms from commercial banks than from official export credit agencies. This was a consequence of the so-called OECD Gentlemen's Agreement that established minimum or "consensus" interest rates for official export credits. (The aim of the agreement was to prevent excessive interest rate competition among OECD governments.) In July 1988, however, the "consensus" interest rate that applied to lending to the Soviet Union was abandoned in favor of a system of market-linked lending rates. Official lending became more attractive, and the volume of Soviet debt to official agencies stabilized. With commercial bank financing less available, Soviet borrowing from official credit agencies is once again increasing.

subsidiary of the De Beers diamond mining group, whereby the Soviet diamond trading organization transferred $1 billion worth of diamonds to London to serve as collateral for a $1 billion loan. What made the deal curious is that it sparked a dispute between the central government and the government of the Russian Federation over who had authority to offer as collateral diamonds mined in the Russian Federation.

In 1990, Soviet authorities published for the first time an accounting of Soviet hard-currency claims on developing countries. (Western analysts had long known that the Soviet Union was aiding a number of developing countries, but the terms of this aid had not been established.) As of November 1, 1989, Soviet officials claimed, developing countries owed the Soviet Union some R42 billion—or about $67 billion at official exchange rates. The face value of these claims far exceeds Soviet debts to the industrialized world, and if they could be collected the Soviet Union would have no net external debt at all. There seems little likelihood, though, that the Soviet claims on developing countries are collectible.

SOME PUZZLES ABOUT SOVIET FINANCE

A review of the Soviet hard-currency balance sheet and Soviet international financial transactions in recent years raises a number of somewhat puzzling issues. Among these is why the Soviet Union has borrowed as heavily as it has in recent years. Through most of the 1980s, Soviet hard-currency export earnings (including the revenues from gold sales) exceeded the value of Soviet hard-currency imports. Normally, this situation would have made the Soviet Union a net lender of hard currency to the rest of the world. Yet, it appears to have been a net borrower. In 1989, the value of imports did exceed export earnings—by about $200 million—and yet Soviet net borrowing in that year was near $10 billion. "Excess" Soviet borrowing in 1990 was more than $7 billion. What was happening to these borrowed funds? The answer seems to be that at least through 1989 (and possibly through 1990) the Soviet Union was passing on several billion dollars a year to client developing countries, either in the form of hard currency or as unpaid-for exports. Essentially, the Soviet Union was using its relatively good credit rating to borrow hard currencies on terms that its client states could never have gotten on their own.

Also puzzling is why Soviet payments for imports fell into arrears in 1989, when VEB had very large holdings of hard currencies on

SOVIET BOND ISSUES

In January 1988, the Soviet Union issued its first ever international bond—a SFr100 million issue in the Zurich market. Seven more international bond issues have followed: four in the deutsche mark market and one each in the Dutch guilder, Italian lira, and Austrian schilling markets. In all cases, the issuer of the bonds was VEB, and at the end of 1990, the face value of all Soviet bonds outstanding was some $1.9 billion. In issuing the bonds, Soviet financial authorities were trying to tap new sources of hard-currency credit. Western banks were or would soon be approaching the limits of their exposure to the Soviet Union, and they could provide further credit to the Soviet Union only if they could sell off some of their exposure to non-bank investors. Bonds provided a vehicle for such sales. Also, Soviet authorities were becoming increasingly aware of the need to extend the maturity of the Soviet debt structure. Bonds, with maturities ranging from 5 to 10 years, would satisfy this need also.

The early Soviet bonds carried relatively low coupon interest rates—the equivalent when swapped into floating rate instruments of about one-quarter of a basis point over LIBOR. Successive issues, though, were less attractive from the Soviet standpoint, and the last issue—a deutsche mark bond issued in January 1990—was widely seen as a failure. This failure, and the general loss of financial market confidence in the Soviet Union, have probably closed the international bond market to the Soviet Union for the next few years.

Also in 1988, the Soviet Union began arranging facilities with Western banks to issue short-maturity floating-rate notes. Facilities to issue as much $920 million in such notes were arranged, but for reasons that remain unclear these facilities have been used very little.

OTHER HARD-CURRENCY ASSETS AND LIABILITIES

In recent years, the Soviet Union has attracted some hard-currency credit from private, nonbank entities in the West. In some cases, this lending has been in the form of traditional trade finance—credits extended by an exporter to make the proposed transaction more attractive to the importer. In other cases, lending by exporters has been involuntary, arising because Soviet importers have not paid for their imports on the schedule originally agreed to. There have also been some deals with Western firms involving rather unusual collateral. The most curious of these was a 1990 arrangement with a Swiss

deposit at Western banks. The answer seems to be that some enterprises and state trading organizations, negotiating international transactions directly for the first time, overextended themselves and found themselves short of the hard currency necessary to meet their obligations. Consistent with the emerging policy of forcing enterprises and trading organizations to take responsibility for their own actions, VEB refused to bail out the overextended entities. Some have suggested that VEB was also attempting to defend its monopoly position in international finance. By keeping perfectly current in meeting its own international obligations, while making it difficult for others to meet theirs, VEB solidified its position as the only organization in the Soviet Union with whom most Westerners would deal.

THE OUTLOOK FOR SOVIET INTERNATIONAL FINANCE

Political and economic circumstances are changing so rapidly in the Soviet Union that any forecast is suspect. There are three elements of the current Soviet financial situation, though, that are likely to have a strong influence on Soviet international finance for the next few years. The first of these is the near total dependence of the Soviet Union on the goodwill of Western governments if it is to borrow hard-currency funds. This dependence is likely to persist, since it will probably be years before internal Soviet political uncertainties are resolved, and because commercial banks are likely to remain wary of Soviet exposure until they are. The policies of Western governments are influenced, of course, by their perceptions of political developments inside the Soviet Union. Ironically, the reduction in East/West tensions in recent years may have given way to an even greater politicization of East/West economic relations.

The second important factor is the short maturity of Soviet international debt. Even with no net inflow of foreign capital, the Soviet Union will have to raise between $15 and $20 billion every year just to replace maturing debt. Soviet financial managers will have to be continuously in international credit markets, and Soviet financial circumstances will remain hostage to Western political sentiment on a week-to-week or month-to-month basis.

Finally, there is some slack in Soviet hard-currency accounts in the form of Soviet financial assistance to other countries. The amount of this assistance probably shrank in 1990. If the Soviet Union were willing to curtail this aid further, however, it could probably reduce its level of foreign borrowing without severe consequences for its own economy.

ACKNOWLEDGMENTS

Invaluable assistance in preparing this report, especially in the tracking down of obscure references, was provided by Jeannette VanWinkle, a graduate fellow in the RAND/UCLA Center for Soviet Studies and the RAND Graduate School of Policy Studies (RGS). Glenys Babcock, also a Center and RGS fellow, was extremely generous in calling my attention to a number of sources that I would otherwise have missed. Robert McCauley of the Federal Reserve Bank of New York was also very helpful in identifying data sources and commenting on early versions of this report. Finally, I am indebted to my RAND colleagues Abraham Becker and Steven Popper for their unusually painstaking reviews of an earlier draft of this report. Whatever errors remain despite their best efforts are mine alone.

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1. INTRODUCTION

Six years of *glasnost* and *perestroika* have brought breathtaking changes in the social and political fabric of the Soviet Union. With these changes have come unprecedented opportunities for both Soviet citizens and Western[1] analysts to observe, to debate, and to understand the forces that are shaping Soviet domestic and foreign policy.

Perestroika has not yet, however, brought successful reform of the Soviet economy. Neither has *glasnost* provided observers—whether inside or outside the Soviet Union—with a clear view of either the shape or the pace of future economic reform. With regard to the economy, the principal product of the new openness of the Soviet policy process seems to have been a clearer understanding of the size of the task facing Soviet economic reformers.

In particular, it is increasingly clear that conversion of the Soviet economy to anything even close to a functioning modern market economy will require massive investment in new capital stock. The prospect seems slim that the necessary investment can be financed by *internal saving alone*. Much of this investment will probably have to be financed by foreign resources. Beyond this, it is possible that the Soviet Union will have to borrow heavily from foreigners merely to satisfy the minimum consumption needs of its population during the next few years, even if nothing is set aside for investment.

THE CHANGING CHARACTER OF SOVIET INTERNATIONAL FINANCE

At the same time that the Soviet Union is facing a growing need to attract foreign financial resources, Soviet access to international credit markets has been seriously impaired. The political and bureaucratic changes brought by *perestroika* have reached the institutions that have managed Soviet international financial relations in the past. Among the consequences of these changes has been a disruption of old ways of doing business. Confusion has arisen, among the Soviet entities responsible for international commercial and financial transactions and among the Western counterparties to these

[1]Throughout this report, I will use "Western" in its political rather than its geographical sense. As I will use the term, the "West" includes Japan and all of the other industrialized market economies.

transactions, over who within the Soviet Union can incur international payment obligations and who is responsible for outstanding payment obligations. Scheduled payments to Western creditors have been missed, and the previously spotless record of the Soviet Union in meeting its international financial obligations has been damaged. These problems, added to serious concerns about political developments in the Soviet Union and to the generally bleak outlook for the Soviet economy, have led many Western financial institutions to reassess the attractiveness of further lending to the Soviet Union. We have witnessed the transformation—in the space of only about a year—of the Soviet Union from a first-class credit risk with easy access to international financial markets to a potential problem debtor unable to attract international credit without special guarantees or collateral arrangements.

The mechanics of Soviet international finance have also changed in recent years. An earlier RAND report[2] described Soviet international financial practice in the mid-1980s. Since that time, however, the Soviet Union has issued its first bonds in international markets, held its first officially sanctioned auctions of foreign currencies, failed to meet international payment obligations for the first time in its history, and become dependent on Western governments for access to international credit. One purpose of this report is to update the profile of Soviet finance that was offered in the earlier report, detailing the changes of the past few years. Perhaps more important, though, this report aims to describe the Soviet international financial situation as it is today. Clearly, both Soviet economic policy and the Soviet economy itself stand at crossroads. Whichever paths they take in the next few years, there will likely be further changes in Soviet international financial relations. To some extent, financial opportunities and constraints will determine which paths are feasible. With this report, I hope to provide a financial context within which these future changes can be understood, to provide a kind of financial baseline from which further changes can be measured.

SOURCES OF INFORMATION

Despite *glasnost*, compiling information on Soviet international financial transactions remains problematic. The Soviet Union publishes no official balance of payments accounts. Details of the Soviet

[2] C. R. Neu and John R. Lund, *Toward a Profile of Soviet Behavior in International Financial Markets*, RAND, R-3524-USDP, August 1987.

international financial position have surfaced much less frequently in the recent debate over economic policy than have details of the domestic economic situation, and information about many specific transactions continues to be closely held. In part, this reflects normal financial prudence. It is often wise to restrict information about specific financial transactions, no matter who the parties to these transactions may be. In part, it reflects the fact that *glasnost* is by no means complete: Statistics on Soviet gold production and gold stocks, for example, are still state secrets. The unavailability of reliable financial statistics, though, is apparently also due to true confusion on the part of Soviet government officials about the state of Soviet international finances: In June 1989, then-Premier Nikolay Ryzhkov shocked both Soviet and Western observers by saying in a speech to the Congress of People's Deputies that Soviet foreign debts totalled some 34 billion rubles (more than $54 billion at prevailing official exchange rates).[3] This figure was much higher than then-current Western estimates of Soviet hard-currency debt. In the months that followed, various Soviet officials offered explanations and adjustments to Ryzhkov's figures, gradually reducing and finally eliminating the discrepancy between Soviet government pronouncements and Western estimates. Many observers interpreted this curious episode as an indication that even the Soviet Premier could not get a correct accounting of something as simple as gross Soviet international debt. For these reasons, most of what we know about Soviet international financial transactions still comes from the Western counterparties to these transactions.

As was the case with the earlier RAND report on Soviet international finance, this report aims to detail what is known and knowable about Soviet international financial practice from open sources. Most Western governments and central banks collect detailed information on the transactions of individual banks and other financial institutions with the Soviet Union (and with most other countries, for that matter). Information about the dealings of particular institutions is regarded as extremely sensitive, and information gathered from financial institutions is made public only in highly aggregated form, with all institutional detail submerged. Detailed institutional information is typically not shared even among agencies within the same

[3]The transcript of Ryzhkov's June 9, 1989, speech is available in FBIS, June 12, 1989, pp. 43–46. The transcript captures parenthetically some of the reaction to Ryzhkov's comments: "So I do not use foreign sources of information on our foreign currency debt, I—perhaps for the first time today—report that the country's foreign debt is now R34 billion. [uproar in the hall]"

national government. In preparing this report, I have not had access to this kind of sensitive officially collected information.

The information contained in this report is drawn from a variety of sources: official publications of governments, central banks, and international organizations; public statements by Soviet and Western officials responsible for financial matters; and the financial press. All of these sources are cited as appropriate in this report. Considerable additional information was gathered in the course of conversations with government officials and financial market participants in the United States, Europe, and the Soviet Union. In a number of these conversations, details of particular transactions were discussed with the understanding that these details would be treated as confidential. Sources of such information are not identified in this report.

This report will focus on the hard-currency financial activities of the Soviet Union—activities that involve the borrowing, placement, payment, or receipt by the Soviet Union of "hard" or convertible currencies. Included among these hard-currency transactions are essentially all Soviet dealings with the industrialized West and most Soviet dealings with developing countries. Through 1990, Soviet economic relations with other members of the Council for Mutual Economic Assistance (CMEA)[4] typically did not involve hard currencies. Most transactions among these countries were carried out in so-called convertible rubles, a currency that was not, despite its name, convertible into Western currencies. From January 1, 1991, however, payments among CMEA countries were shifted to a hard-currency basis. In the future, it will no longer be necessary to identify some subset of total Soviet transactions with foreign countries as being hard-currency transactions. With the exception of some barter arrangements, all Soviet international economic activities will be carried out in hard currencies.[5]

[4]The members of the CMEA were the Soviet Union, the German Democratic Republic, Poland, Rumania, Hungary, Czechoslovakia, Bulgaria, Cuba, Vietnam, and Mongolia.

[5]Because all of the former CMEA countries are likely to find themselves short of hard currency, barter transactions may account for a significant portion of trade among these countries for at least the next few years.

THE PLAN OF THIS REPORT

Section 2 of this report provides a brief description of the organizations responsible for Soviet international financial transactions and notes how these institutions and their responsibilities have changed in recent years. Section 3 provides an overview of the Soviet hard-currency balance of payments and net international borrowing during the Gorbachev era. Sections 4 through 7 offer a detailed discussion of the various components of the Soviet hard-currency balance sheet. They describe the various types of assets and liabilities that are represented in this balance sheet and provide at least an approximate accounting of net and gross Soviet hard-currency debts. Section 8 discusses a number of questions that have arisen in recent years about the motivations for and the methods of Soviet international finance, focusing on those aspects of Soviet financial practice that have been most puzzling to Western analysts. In particular, this section discusses the payment arrearages that arose in late 1989. The report concludes in Sec. 9 with some necessarily speculative observations on the outlook for Soviet international finance.

2. THE INSTITUTIONS OF SOVIET INTERNATIONAL FINANCE

THE BANK FOR FOREIGN ECONOMIC ACTIVITIES

The principal institution through which the Soviet Union conducts its international financial affairs is the Bank for Foreign Economic Activities of the USSR (Vneshekonombank, or VEB). VEB was established on January 1, 1988, as the successor institution to the Bank for Foreign Trade of the USSR (Vneshtorgbank), which in turn was established in 1924. The change from Vneshtorgbank to Vneshekonombank was bureaucratic rather than substantive. VEB describes itself as a "state institution" in contrast with Vneshtorgbank, which was a "joint-stock company."[1] VEB's purposes and operations, though, are the same as those of its predecessor. It specializes in "international settlements and financing of foreign trade and other forms of international business." More specifically, VEB "takes deposits and grants loans to foreign and international banks and other organizations, keeps accounts in Roubles for foreign companies and organizations and accounts in foreign currencies for domestic clients, provides project and trade finance, runs bank accounts for state loans granted by and to the USSR, and trades foreign currencies and a variety of commodities."[2] VEB has branches throughout the Soviet Union as well as a branch in Zurich and representative offices in New York, Cairo, and Bombay.

Before 1989, a description of the institutions of Soviet international finance could have ended at this point. VEB or its predecessor carried out essentially all Soviet international financial transactions. All hard-currency payments were made by VEB; all hard-currency borrowing was done by VEB; all hard-currency assets were held by VEB. In recent years, though, this situation has begun to change.

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[1]The principal shareholders in Vneshtorgbank were the State Bank of the USSR (Gosbank), the Ministry of Finance, and the Ministry of Foreign Trade. A variety of other ministries, state committees, and foreign trade organizations were minor shareholders.

[2]This description of VEB's activities appeared on p. 7 of the prospectus for bonds issued in Frankfurt by VEB in 1988.

THE REFORMS OF THE LATE 1980s

In January 1987, some selected Soviet ministries, foreign trade organizations, and enterprises were given limited freedom to enter directly into commercial transactions with Western counterparties. Previously, all such transactions had been been carried out through the Ministry of Foreign Trade. Beginning in 1987 also, entities that earned hard currency through export sales were permitted to retain a portion of these earnings on deposit at VEB in so-called "retention accounts."[3] VEB pays interest on these accounts, but at rates below those prevailing in Western financial markets. Early in 1989, this freedom to engage in trade activities and to hold foreign-currency accounts at VEB became general, and by the beginning of 1990 some 30,000 entities were reportedly authorized to engage directly in foreign trade.[4]

In theory at least, it is also permissible for ministries, trade organizations, and enterprises to hold hard-currency balances in foreign banks, with the prior approval of VEB. Conversations both with Soviet financial authorities and with Western bankers confirm, however, that as recently as mid-1990 none of these other entities held such accounts. All Soviet hard-currency assets held abroad were in the name of VEB. Whether this was because other entities had not sought permission to maintain foreign accounts or because VEB has been reluctant to grant the necessary permission is unclear. However, because VEB pays below-market rates of interest, it is hard to believe that other entities have not sought permission to hold accounts abroad.[5] Indeed, one hears stories in Western financial circles of Soviet export organizations engaging in what amount to barter arrangements, converting hard-currency export earnings into Western goods to be shipped to the Soviet Union. To take hard-

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[3]A substantial "tax" is placed on hard-currency earnings. In November 1990, Soviet President Gorbachev issued a decree ordering Soviet exporting enterprises to surrender substantial fractions of their hard-currency earnings during 1991 to help finance the Soviet Union's foreign debt. Forty percent of all hard-currency export receipts are to be sold to VEB at the "commercial" exchange rate. The fraction of the remaining 60 percent that may be retained varies from industry to industry, with higher "retention quotes" being permitted for exports of products that embody large amounts of domestic processing. See "Gorbachev's Currency Decree," *The Financial Times*, November 3, 1990, and "Decree of Formation of Hard Currency Reserves for 1991," *Ekonomika i zhizn*, January 1, 1991, p. 25. The text of the decree itself was published in *Pravda*, November 3, 1990. A translation is available in FBIS-SOV-90-216, November 7, 1990, pp. 54–55.

[4]*Business Eastern Europe*, March 9, 1990, p. 95.

[5]Gorbachev's decree of November 1990 requiring all hard-currency interest earnings to be turned over to the state, though, presumably eliminated this incentive.

currency earnings directly back to the Soviet Union would mean turning over a share of these earnings to VEB. Better, apparently, to bring back goods over which the entity in question can exercise more complete control.

Also in early 1989, Soviet ministries, foreign trade organizations, and enterprises were given the right to borrow hard currencies directly from Western banks and other entities, providing that they received prior approval from VEB. At least initially, VEB did not give the necessary approval easily. In February 1990, nearly a year after VEB granted general permission for borrowing by other entities, VEB officials told a visiting delegation of foreign bankers that approvals for foreign borrowing had been given to only 70 entities.

Previously, Western banks and other financial institutions had dealt exclusively with VEB. Soviet officials had always maintained that no state guarantees were attached to borrowing by VEB. The state's stake in VEB, they insisted, was limited to the bank's capital (set by statute at 1 billion rubles). Given the nature of the Soviet economy, however, and the fact that VEB was the sole conduit for Soviet international financial transactions, Western creditors presumed a moral and practical commitment on the part of the Soviet state to meet VEB's international obligations that was every bit as strong as a formal state guarantee. Also, VEB and its predecessor institution had maintained a flawless payment record. (VEB apparently still does.) As a consequence, Western financial institutions were generally very comfortable dealing with VEB.

Beginning in 1989, though, new Soviet "names" began to appear in international credit markets. Ministries, foreign trade organizations, and in some cases republic governments that had never had any direct financial dealings with the West began to seek credit from Western banks. In many cases, the proposed credits would have carried "guarantees" from one or another union or republic government entity. Soviet authorities, no less than Western bankers, were confused about the meaning of such guarantees and about who bore ultimate responsibility for repaying such loans.[6]

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[6]In the spring of 1990, a Soviet official told me that he simply did not know what it meant for a ministry or a republic government to guarantee a foreign debt. Soviet law and practice regarding the respective powers and responsibilities of various levels of government were and are too unsettled to permit clear answers to questions like these. Confusion over the meaning of ministerial commitments in particular became even more acute after July 1989, when a major consolidation of Soviet ministries eliminated or merged a number of ministries essentially overnight.

At about this same time, some Western creditors encountered payment delays from some Soviet organizations engaged in import activities. (For more on this, see Sec. 8.) All VEB obligations were apparently being met on schedule, and Western banks became reluctant to extend credits that were not guaranteed by VEB. Ironically, the result was that bankers were more comfortable making loans to VEB without any explicit state guarantee than they were making loans directly to Soviet government ministries or to other entities that enjoyed explicit government guarantees. Despite reform of Soviet regulations governing international finance, few Soviet entities other than VEB have had any access to Western credit markets since the end of 1989.

Further changes in the institutions of Soviet international finance may lie in the near future. The legal basis already exists for other banks in the Soviet Union, which serve particular sectors of the economy, to raise hard-currency funds and handle international payments on behalf of various Soviet entities. Licenses to engage in foreign economic activity have been issued to specific banks.[7] So far, though, these other banks have shown little interest in taking on such a role. Also, VEB has given no particular indication that it is interested in giving up its current near-monopoly on international financial transactions. On the contrary, one hears allegations that VEB has actively opposed efforts by other banks to take on a larger role in international finance.

SOVIET-CONTROLLED BANKS IN THE WEST

The Soviet Union also controls five banks outside the Soviet Union: Moscow Narodny Bank, Ltd., in London; Banque Commerciale pour L'Europe du Nord S.A. (Eurobank) in Paris; Ost-West Handelsbank AG in Frankfurt; Banque Unie Est-Ouest S.A. in Luxembourg; and Donau-Bank AG in Vienna. These banks specialize in financing East-West trade, but they are also active participants in local wholesale money markets and foreign exchange markets.

Soviet-controlled banks in the West are all incorporated and licensed and they all operate in accordance with banking regulations in their host countries. For all legal and regulatory purposes, Moscow Narodny Bank, Ltd., is, for example, a British bank. The only thing

[7]"The Way to Improve the Health of the Ruble?" [interview with Gosbank Chairman V. Gerashchenko], *Pravda*, July 17, 1990. Translation in FBIS-SOV-90-141, July 23, 1990, pp. 52–54.

that distinguishes Moscow Narodny from other British banks is that it is fully owned by a consortium of Soviet entities. Prominent in this consortium are the State Bank of the USSR (Gosbank) and VEB. For most statistical purposes, these Soviet-controlled banks are not distinguished from other Western banks. When the Bank of England, for example, reports the total value of loans outstanding from British banks to the Soviet Union, loans made by Moscow Narodny to VEB are included. Similarly, when the U.S. Federal Reserve reports the total U.S. bank claims on and liabilities to residents of France, U.S. bank balances vis-à-vis Eurobank are included.

Until recently, there was a sixth Soviet-controlled bank operating in the West: Wozchod Handelsbank, in Zurich. Following large losses on gold and foreign exchange trading, however, the bank was liquidated in 1985. It has been replaced by a branch of VEB in Zurich. As the major stockholder in Wozchod, VEB essentially absorbed all the losses incurred by the former bank and took over its operations directly.

3. THE SOVIET HARD-CURRENCY BALANCE SHEET

A convenient starting point for a survey of Soviet international financial activity is with a review of what is known about Soviet hard-currency assets and liabilities—that is, with a review of the Soviet hard-currency balance sheet.

SOVIET HARD-CURRENCY DEBT

Table 3.1 shows estimates of the gross and net hard-currency debt of the Soviet Union at years end 1989 and 1990. These estimates are derived by putting together estimates by the Bank for International Settlements (BIS), the Organization for Economic Cooperation and Development (OECD), and the U.S. Central Intelligence Agency (CIA). The estimates of these agencies reflect the most comprehensive efforts at collecting primary data on Soviet hard-currency assets and liabilities. Other estimates of Soviet debt are computed, but they generally reflect adjustments of one sort or another made to the estimates reported in Table 3.1.

Table 3.1

Soviet Hard-Currency Debt at Years End 1989 and 1990 (in billions of U.S. dollars)

	1989	1990
Gross liabilities to Western banks	44.8	42.1
Liabilities to official export credit agencies	5.7	5.9
Liabilities to private, nonbank entities	1.8	2.1
Arrearages on trade payments	0.5	5.0
Gross debt	52.8	55.1
Claims on Western banks	14.7	8.7
Net debt	38.1	46.4

SOURCES: BIS, OECD, and CIA.

NOTE: Including assets and liabilities of the two CMEA banks: the International Bank for Economic Cooperation (IBEC) and the International Investment Bank (IIB).

In the sections that follow, we will discuss in detail the nature of the various assets and liabilities that make up the Soviet hard-currency balance sheet and how these assets and liabilities have grown or decreased in recent years. Two important facts about Soviet international finance, though, are apparent even in these simple accountings of net and gross debt. The first is that, with a gross debt of $51 or $52 billion, the Soviet Union is not among the world's largest borrowers. Among developing countries, Brazil ($111 billion), Mexico ($96 billion), India ($63 billion), Argentina ($65 billion), and Indonesia ($53 billion) all had larger gross external debts than the Soviet Union at the end of 1989. The second important observation is that the Soviet Union maintains extensive hard-currency asset holdings, although these holdings were reduced significantly during 1990.

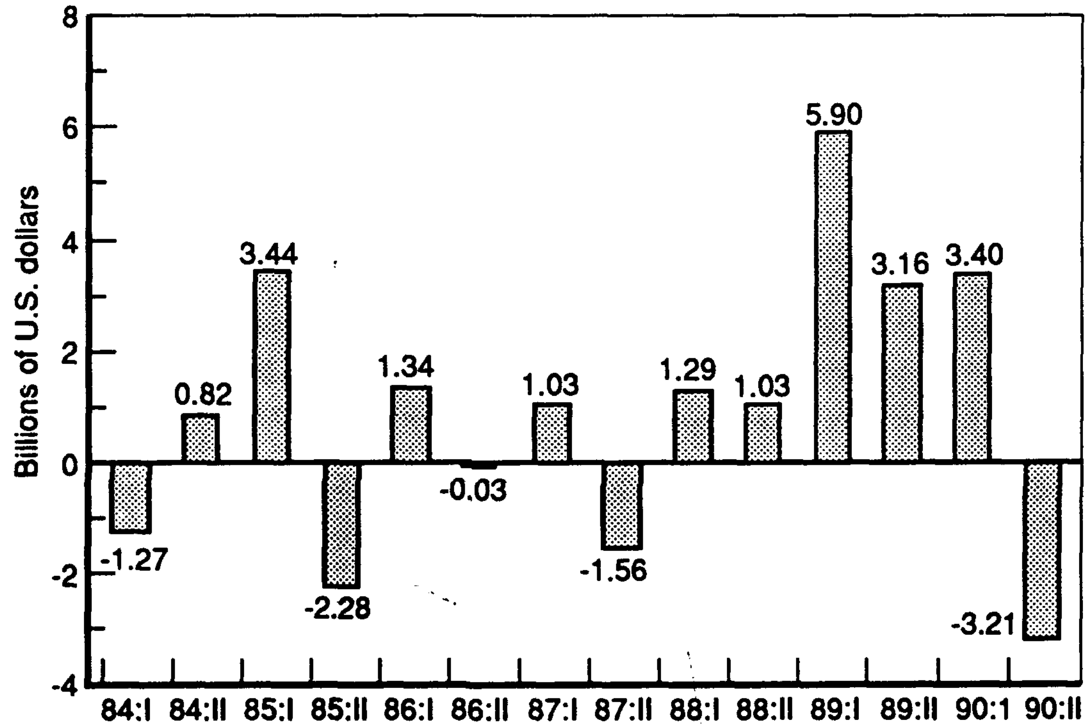
HOW THE SOVIET BALANCE SHEET HAS CHANGED

At any point in time, the overall Soviet balance sheet is the cumulative result of all previous Soviet net borrowings and accumulations of hard currencies. Changes in the balance sheet during any period reflect net new borrowing, net repayments of outstanding debts, and net earnings or payments of hard currencies. Balance sheet totals are also influenced, though, by changes in the values of the assets and liabilities. The most important of these changes are the consequences of changes in currency exchange rates. Many Soviet assets and liabilities are denominated in currencies other than dollars, and the dollar value of these assets and liabilities fluctuates as the value of the dollar fluctuates relative to other currencies. Thus, the dollar value of Soviet net or gross hard-currency debt can change even if there is no change in the underlying asset and liability accounts.

To form an accurate picture of the pattern of net Soviet borrowing in recent years, it is necessary to adjust changes in balance sheet totals for exchange rate changes. This kind of adjustment is possible for the principal classes of assets and liabilities that appear in the Soviet hard-currency balance sheet. Since 1984, the BIS has reported adjusted changes in Soviet assets and liabilities vis-à-vis Western commercial banks. Since 1986, the OECD has also calculated adjusted changes in Soviet debt to official export credit agencies. Combining these figures and adding estimates for changes in debts to

private nonbanks, Fig. 3.1 provides at least a rough picture of the pattern of net Soviet borrowing in recent years.[1]

Contrary to the representations of some authors,[2] the early years of Mikhail Gorbachev's reform efforts were not marked by heavy dependence on external finance. Gorbachev came to power in March 1985. In the three and one-half years from July 1985 (our statistical sources force us to calculate such things in half-year intervals) through the



SOURCES: BIS, OECD, and CIA.
NOTE: Annual CIA estimates of net changes in outstanding promissory notes have been divided equally between half-years.

Fig. 3.1—Changes in Soviet net debt, adjusted for exchange rate changes (by half-years)

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[1]For 1984 and 1985, I have calculated rough adjustments for Soviet debt to official export credit agencies on the assumption that the currency composition of Soviet debt to official lenders is roughly the same as the currency composition of Soviet debt to banks. In later years, these rough adjustments agree reasonably well with the adjustments calculated by the OECD, and so I have used them to extend the series of adjusted changes in Soviet debt to official creditors back to 1984.

[2]See, for example, Judy Shelton, *The Coming Soviet Crash*, The Free Press, New York, 1989, p. xv.

end of 1988, net Soviet borrowing amounted to only about $800 million. For comparison, during that same period Soviet hard-currency revenues from merchandise exports were the equivalent of about $106 billion. During the early years of the Gorbachev regime, foreign lending was not an important contributor to Soviet economic performance. Although overall net borrowing during this period was modest, there were important changes in the composition of Soviet debt. Soviet debt to Western banks increased significantly during the early years of the Gorbachev era. This was largely offset, though, by reductions in Soviet debt to foreign official lenders.

The patterns of Soviet international finance changed abruptly in 1989, when the Soviet Union embarked on a borrowing binge. In 1989, net borrowing amounted to $9.1 billion. Although it was not widely recognized at the time, near the end of 1989 there was also considerable involuntary lending to the Soviet Union by Western exporters who did not receive timely payment from Soviet importers. Estimates of the size of these payment arrearages are necessarily speculative, but it would probably not be too far off the mark to say that the total increase in net Soviet hard-currency liabilities during 1989 was in the neighborhood of $10 billion. Heavy net borrowing continued in the first half of 1990. By the second half of 1990, though, the Soviet Union could find few willing lenders and its net external debt began to decline.

THE SOVIET HARD-CURRENCY CURRENT ACCOUNT

The counterpart to the sharp rise in Soviet net foreign borrowing was a deteriorating current account position (see Table 3.2). Both the merchandise trade balance and the current account balance peaked in 1987, and both had moved into deficit by 1989.

A part of the decline in both balances is accounted for by the disappointing performance of the Soviet oil industry in the late 1980s. By far the leading Soviet export industry, oil and oil products accounted for 39 percent of all Soviet exports by value in 1985. Falling oil prices cut into oil export earnings in 1988. As prices began to rise again in 1989, though, Soviet oil production began to falter, a victim of inefficient production technology and a scarcity of such critical production materials as piping. These problems forced reductions of oil export volumes in both 1989 and 1990.

As export earnings lagged, hard-currency outlays for imports surged. Growing demands for more consumer goods (necessarily imported),

Table 3.2

Soviet Current Account in Convertible Currencies, Transactions Basis (in billions of U.S. dollars)[a]

	1985	1987	1987	1988	1989	1990[b]
Trade balance	1.3	3.6	8.2	4.8	-0.1	-5.7
Exports	(27.5)	(26.8)	(31.3)	(33.4)	(35.2)	(36.9)
Imports	(-26.3)	(-23.2)	(-23.1)	(-28.7)	(-35.4)	(-42.6)
Services balance	-1.8	-1.8	-1.7	-3.3	-3.8	-5.0
External debt-service portion	N.A.	(-7.8)	(-8.8)	(-8.2)	(-9.4)	(-13.3)
Gold sales	1.8	4.0	3.5	3.8	3.7	3.6
Current account (excluding gold)	-0.5	1.8	6.6	6.6	-3.9	-10.7
Current account (including gold)	1.3	5.8	10.1	5.4	-0.2	-7.1

SOURCE: *A Study of the Soviet Economy,* International Monetary Fund, The World Bank, Organizatión for Economic Cooperation and Development, European Bank for Reconstruction and Development, February 1991, Vol. 1, pp. 58–59.

[a]Converted at average official exchange rate for each year.

[b]Projection.

reduced central control of importing enterprises, and the rebuilding efforts in the wake of the disastrous 1988 Armenian earthquake all contributed to sharply increased import spending.

A final factor adding to the need for foreign borrowing during the late 1980s was foreign borrowing itself. Payments for servicing the Soviet Union's external debt grew from just over $8 billion in 1987 to more than $13 billion in 1990.

The sharp deterioration in the Soviet current account position during the late 1980s is consistent with a large increase in foreign borrowing. The amount of this borrowing appears to have been more than was necessary to finance the emerging current account deficits. (Indeed, before 1989, the current account was in surplus.) We will return in Sec. 8 to a discussion of this apparently excessive Soviet borrowing.

4. THE SOVIET BALANCE SHEET VIS-À-VIS WESTERN BANKS

Borrowings from and deposits in Western commercial banks dominate the Soviet hard-currency balance sheet. At the end of 1990, debts to Western commercial banks accounted for about three-quarters of Soviet total gross debts, and deposits in Western banks accounted for virtually all of Soviet hard-currency assets.

The principal source of information on Soviet assets and liabilities vis-à-vis commercial banks is the Bank for International Settlements (BIS), an international institution based in Basel, Switzerland. Since 1977, the BIS has compiled quarterly estimates of the claims (e.g., loans outstanding) and liabilities (e.g., deposits taken) of Western commercial banks vis-à-vis most countries in the world. (The BIS has also compiled annual figures for earlier years.) Bank claims on and liabilities to the Soviet Union are included in these quarterly compilations. Within the BIS "reporting area,"[1] data on international lending and deposit-taking are reported by commercial banks to their respective central banks.[2] These central banks then forward the information to the BIS, where it is aggregated to produce figures reflecting the overall position of the Western banking system with respect to borrowers and depositors in particular countries.

BIS reporting arrangements are not perfect. Some Soviet assets and liabilities vis-à-vis Western banks are undoubtedly missed in the accounting. Over the years, though, the BIS reporting area has expanded so that it now includes nearly all important international financial centers.[3] BIS figures are widely seen as reliable, not least because they are based on reports from central banks, which have the authority to audit the books of commercial banks in their respective

[1]The BIS reporting area includes the United States, Japan, Canada, Australia, New Zealand, all of Western Europe, and the major "offshore" financial centers: the Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles, Singapore, and Panama. (In Panama, only branches of U.S. banks report.)

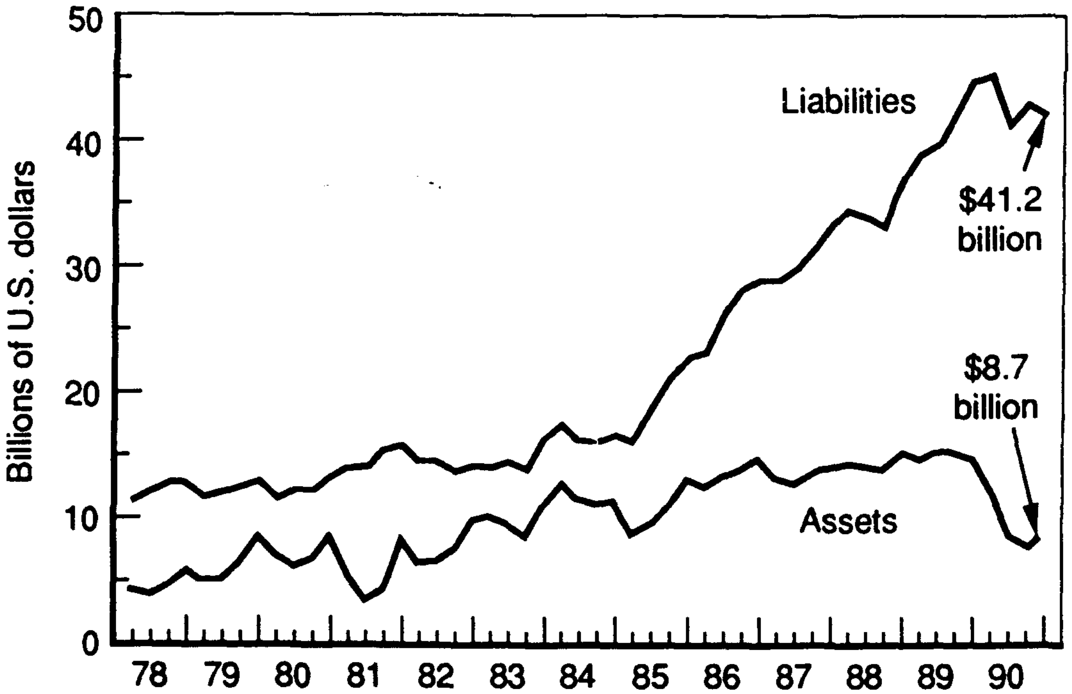
[2]Although most bank claims on foreign countries are in the form of traditional loans, banks are also required to report to their central banks other types of claims on foreign countries that they may hold. In particular, banks are supposed to report their holdings of bonds issued by entities in foreign countries.

[3]The most important commercial banks that do not report to the BIS are those located in Saudi Arabia, Kuwait, and the United Arab Emirates.

countries. Certainly, the BIS provides the most comprehensive publicly available accounting of Soviet dealings with Western banks.

Figure 4.1 shows the dollar values of Soviet assets and liabilities vis-à-vis commercial banks in the BIS reporting area. What is striking about this figure is the rapid divergence of Soviet assets and liabilities after 1984. Since then, the value of liabilities has increased sharply, and the value of Soviet deposits in Western banks remained more or less the same until late 1989. At the end of 1990, total Western bank claims on the Soviet Union stood at $41.2 billion. Soviet claims on the banks were $8.7 billion, leaving a net Soviet indebtedness to the banks of $34.1 billion. This compares with a net debt to Western banks of only $5.3 billion at the end of 1984.

Also noteworthy are the recent sharp declines in both Soviet assets and liabilities. The decline in Soviet liabilities reflected a growing unwillingness of Western banks to renew short-term credits to the Soviet Union. As short-term loans became due, they were repaid but no new loans were made. The result was a sharp decline in total



SOURCE: BIS.

Fig. 4.1—Soviet assets and liabilities vis-à-vis BIS reporting banks

Soviet liabilities to Western banks during the second quarter of 1990. The decline in Soviet assets began in the third quarter of 1989, when the Soviet Union was forced to draw on its hard-currency reserves to finance increased import needs and to replace the credits that banks were no longer willing to offer.

Because Soviet assets and liabilities are shown in U.S. dollar-equivalents, Fig. 4.1 distorts somewhat the temporal pattern of Soviet borrowing from and deposit placements in Western banks. During 1985 and 1986, in particular, the dollar declined sharply in value relative to other major currencies, inflating the dollar-equivalent value of both sides of the Soviet balance sheet. The rise in both gross and net debt shown as occurring during 1985 and 1986, therefore, is somewhat overstated.

Figure 4.2 shows changes in Soviet liabilities, assets, and net debt vis-à-vis Western banks from one quarter to the next, adjusted for changes in exchange rates. After adjustment for exchange rate changes, the rise in Soviet net debt to Western banks from the end of 1984 to the end of 1990 is $20.1 billion—still quite substantial but somewhat less than the $29.2 billion suggested by the unadjusted amounts reflected in Fig. 4.1.

Figure 4.2 also shows clearly the growing reluctance of Western banks to extend credit to the Soviet Union.[4] From the second quarter of 1989, the volume of new lending by Western banks to the Soviet Union (reflected in the growth of Soviet liabilities to banks, shown in the top panel of Fig. 4.2) declined continuously, culminating in a dramatic reduction in loans outstanding during the second quarter of 1990. (After adjustment for exchange rate changes, this decline was $4.6 billion, a bit more than 10 percent of total Western bank exposure to the Soviet Union at the beginning of the quarter.) A second sharp decline (of $1.9 billion after adjustment for exchange rate change) marked the last quarter of 1990. The second panel in Fig. 4.2 shows that the Soviet Union made up for at least a part of the shortfall in lending by liquidating its deposits in Western banks; in each quarter from mid-1989 through mid-1990, Soviet financial managers withdrew successively larger amounts from these deposits. The bottom panel of Fig. 4.2 shows that beginning in late 1988 the net exposure of Western banks to the Soviet Union (total loans outstanding to the Soviet Union minus Soviet deposits) began to grow more rapidly than it had over the previous five years. Despite reduced lending and deposit withdrawals, the net exposure of Western banks to the Soviet Union continued to grow throughout 1989 and into the 1990, declining only in the second and fourth quarters of 1990.

[4]The statistics that underlie Fig. 4.2 are provided in the appendix.

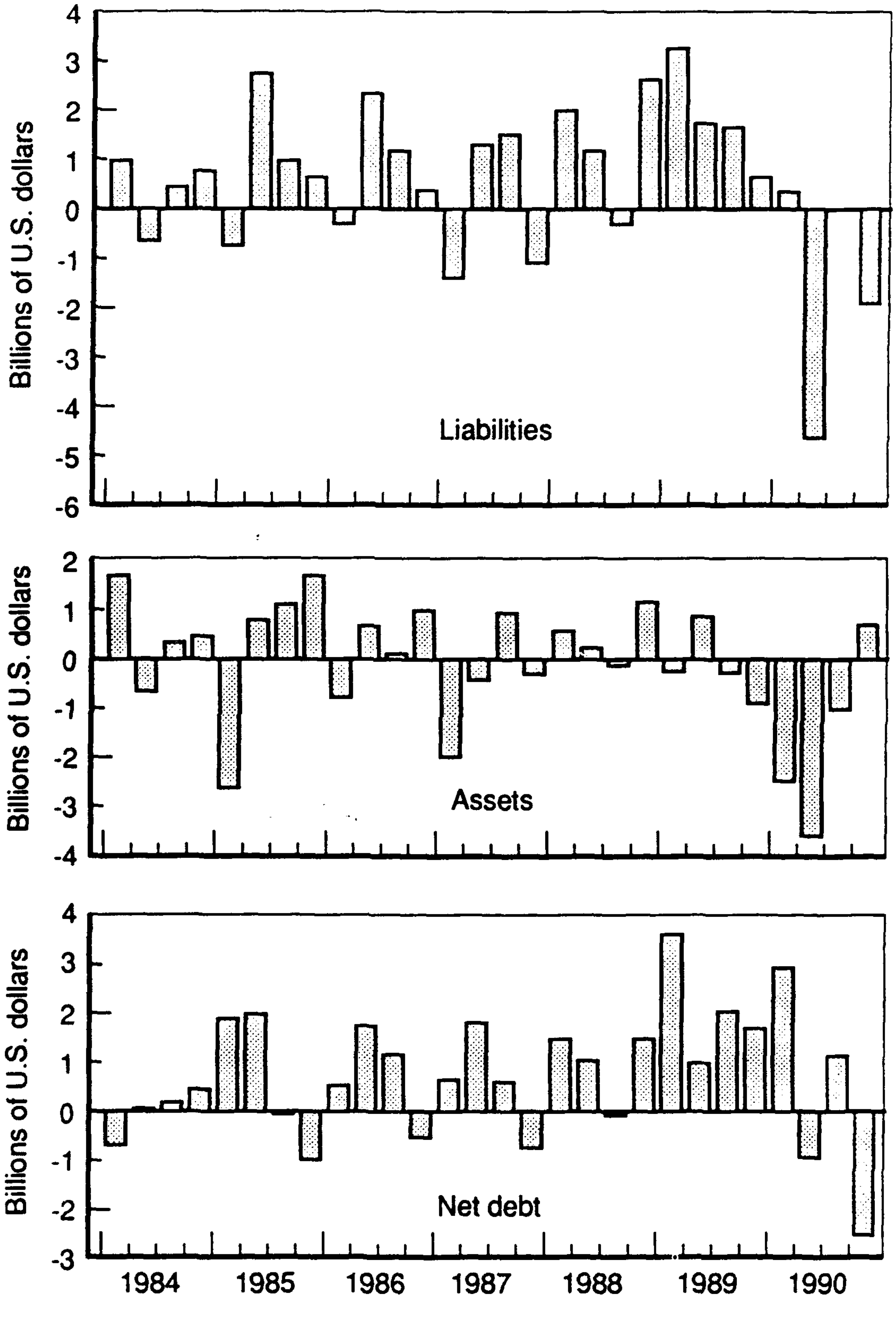


Fig. 4.2—Soviet balance sheet vis-à-vis reporting banks: changes, adjusted for exchange rate changes

THE CHARACTER OF SOVIET HARD-CURRENCY LIABILITIES

The liabilities of the Soviet Union to Western banks are of four principal types: medium-term syndicated loans, short-term trade credits, interbank credit, and bank holdings of debt instruments (such as bonds) issued by the Soviet Union. Syndicated loans are medium-term loans (usually with maturities of five to eight years) extended jointly by groups or "syndications" of Western banks. Often, these loans are made to finance specific imports or imports associated with specific projects, such as the construction of a pipeline or a major industrial plant.[5] Typically, these are floating-rate loans, with interest rates adjusted every six months and maintained at a fixed spread above some reference interest rate. The usual reference rate for international lending is the six-month London interbank offer rate (LIBOR), the rate that major banks pay on large deposits from other banks.

Short-term trade financing extended by banks is usually of a few months maturity and is always associated with specific trade transactions. In extending these credits, a Western bank essentially pays a Western exporter for goods shipped to the Soviet Union. The bank then has a claim on some Soviet entity (probably VEB, but in recent years possibly some other Soviet trade entity) for the value of the shipment. The Western bank will receive payment some months later when the goods arrive in the Soviet Union. The bank receives payment in full from the importer for the goods shipped but pays the exporter somewhat less than the full value of the shipment. The difference is the equivalent of an interest charge. In some cases, the original credit is extended by the Western exporter, who then sells the resulting claim (at a discount from face value) to a bank. (The market in such trade claims is known as the *a forfait* market.) Such arrangements are typical in all international trade, not just trade between Western countries and the Soviet Union. What distinguishes

[5]The linkage to particular trade transactions is more a formality than a reality. Money, of course, is fungible, and hard-currency funds borrowed to finance essential imports will free funds (from export earnings, say) for whatever purposes Soviet authorities might desire. Thus, there is always some uncertainty about which activities are actually being financed at the margin. The continuing decentralization of Soviet foreign trade and financial activity may reduce slightly the ease with which hard-currency funds may be shifted from one agency, enterprise, or purpose to another. But the bulk of Soviet hard-currency borrowing is still managed by central authorities through VEB, and the ability of these authorities to allocate hard-currency funds at the margin presumably remains intact.

trade financing with the Soviet Union is that most Western bank claims are on VEB, rather than on a variety of private banks and importing firms, as is typical in trade among Western countries.

Rather than negotiating a new trade credit for each commercial transaction that it is engaged in, VEB has established a number of revolving trade financing facilities with syndicates of Western banks. These facilities provide standing lines of credit to be used for specified types of trade transactions. The credit lines are drawn on and repaid as required to finance imports, as long as the total balance outstanding remains below the maximum credit limit. These credits usually carry floating interest rates, similar to those for syndicated loans.

Interbank lines of credit typically provide very-short-term credit from Western banks to VEB. The credits are in the form of very-short-term deposits by Western banks in VEB and are intended principally as working balances to facilitate payments between VEB and Western banks. The interest rates paid on these interbank deposits fluctuate and are generally close to LIBOR. VEB maintains interbank credit lines with its major correspondent banks in the West (in 1985, Vneshtorgbank claimed to have correspondent relationships with some 300 Western banks)[6] and draws on these lines as necessary in its day-to-day operations. Credit advanced through interbank lines is not tied to particular trade transactions. Neither the maximum size of these lines nor the extent to which they are drawn is made public (although outstanding interbank credits are included in the total claims on the Soviet Union reported by banks to the BIS). Most observers believe, however, that outstanding credit to the Soviet Union through short-term interbank deposits at any particular time is a relatively small part of the total foreign debt of the Soviet Union.

From time to time Western banks have also made bilateral or "club" loans to VEB, to its predecessor Vneshtorgbank, and possibly in recent years to other Soviet entities. These are private transactions between Soviet borrowers and particular Western banks, and the terms and sometimes even the existence of these loans are not made public. Such bilateral loans are supposed to be reported, however, to central banks and eventually to the BIS.

Since 1988, the Soviet Union has been issuing hard-currency denominated bonds and notes. (For more on these, see Sec. 6.) Although these securities can be sold to private, nonbank investors, it is widely

[6] Yuri Ivanov, "The 60th Anniversary of the Bank for Foreign Trade (Vneshtorgbank) of the USSR," *Foreign Trade*, September 1985, pp. 8–14.

believed that most are still held by the banks that underwrote their issuance. Banks are required to report such holdings to their central banks and thence to the BIS.

Although BIS reporting of Western bank lending to the Soviet Union is widely considered to be very good, it is not exhaustive. Missing from BIS estimates of Soviet liabilities to banks are credits extended to the Soviet Union by banks outside the BIS reporting area. There have been stories (seldom officially confirmed) of such loans—primarily from Arab banks. The extent of such borrowing in the past is unknown. There seems to be a widespread (but unsubstantiated) belief that it was substantial during the late 1970s and early 1980s, but that it was subsequently much reduced, if for no other reason, because of the decreasing hard-currency surpluses to be disposed of by the oil-producing countries of the Middle East. It appears, though, that banks from the Persian Gulf region may once again be emerging as important lenders to the Soviet Union (if in fact they ever were). A $50 million loan to VEB from the Abu Dhabi Commercial Bank and Abu Dhabi Investment Company was made public in early 1988. At the time, it was reported that this was the first loan from the United Arab Emirates to the Soviet Union.[7] In November 1990, the six member nations of the Gulf Cooperation Council[8] offered a $4 billion package of financial assistance to the Soviet Union. Details of the offer have not been made public, but it was reported to include both direct assistance and loans.[9] Under current reporting arrangements, loans advanced by banks in the Gulf region will probably not show up in the BIS accounting of bank claims on the Soviet Union. Bahrain is the only member of the Gulf Cooperation Council whose banks' activities are reported to the BIS.[10]

[7]*Business Eastern Europe*, April 26, 1988, p. 136.

[8]Saudi Arabia, Kuwait, the United Arab Emirates, Bahrain, Qatar, and Oman.

[9]Tony Walker, "Gulf States Offer Soviets $4 Billion in Emergency Aid," *The Financial Times*, November 29, 1990.

[10]Neither will loans made by the governments of Gulf countries show up in the standard accountings of Soviet debt. The OECD collects information on trade credits provided by the governments of OECD member countries. The Gulf states, however, are not members of the OECD, and loans by these governments will therefore not be included in OECD totals.

THE TERMS OF SOVIET BANK BORROWING

Before the fall of 1989, the Soviet Union enjoyed good and generally improving terms in its borrowing from Western banks. Table 4.1 shows the terms for publicly reported syndicated credits through 1989. (Unpublicized credits and credits guaranteed by Western governments are not included in these tabulations.) During the early 1980s, the spreads on loans to the Soviet Union increased and maturities shortened. This reflected financial market concerns both over the creditworthiness of a number of East European debtors—Poland first ran into debt trouble in 1981—and over the safety of international lending in general, as Mexican and Brazilian debt problems attracted considerable attention beginning in 1982.

Table 4.1

Terms of Soviet Borrowing: Publicly Reported Syndicated Credits

Year	Average Spread (% above LIBOR)	Average Maturity (yr)
1976	1.03	5.00
1977	1.09	6.75
1978	0.73	8.50
1979	0.57	7.85
1980	(a)	(a)
1981	0.56	4.75
1982	o.62	5.25
1983	0.92	5.38
1984	0.63	6.50
1985	0.25	8.00
1986	0.25	8.00
1987	0.25	8.00
1988	0.19	7.20
1989	0.22	7.30

SOURCES: 1976–1984, *Euromoney*, November 1984, p. 18; 1985–1987, *Euromoney*, various issues; 1988, 1989, *Eurostudy*, 1990/91.

NOTE: Excluding guaranteed credits and credits to entities other than VEB.

[a]No credits negotiated in 1980.

From 1983 on, though, the Soviet Union enjoyed steadily improving terms. By the late 1980s, the terms of syndicated credits to the Soviet Union placed it among the most favored sovereign borrowers. In March of 1987, for example, the First National Bank of Chicago managed a $200 million syndicated loan to the Soviet Union with a maturity of eight years and a spread of only one-eighth of a percentage point above LIBOR. This put the Soviet Union on a par with such countries as Portugal, Thailand, Belgium, and Canada, which were then also able to borrow at one-eighth over LIBOR. As recently as September 1989, VEB was able to arrange a five-year, $100 million syndicated credit managed by Banca Commerciale Italiana at 25 basis points[11] over LIBOR.

Banks typically charge fees for originating loans, usually equal to a few percentage points of the total value of the loan. Whereas it is common for spreads, maturities, and principal repayment schedules for international loans to be made public, fees are usually kept confidential. Conversations with bankers suggest that during the late 1980s Soviet financial managers were tough bargainers, demanding and often getting attractive fee arrangements.[12] Some observers have suggested, however, that the Soviet Union attached such importance to public recognition of its status as a first-class credit risk that on some occasions it may have been willing to pay somewhat higher fees in private in exchange for attractive and publicly announced spreads and maturities. Unfortunately, no firm evidence on this point is available.

When Soviet entities other than VEB appeared in credit markets in 1989, clear distinctions seemed to be drawn by lenders between the well-known borrower, VEB, and newer "names." Terms offered to other entities were nowhere near as attractive as those offered to VEB. In November 1989, for example, shortly after VEB was able to borrow at one-quarter of a percentage point over LIBOR, AKP Sovkomflot, the Soviet international shipping agency, had to pay seven-eighths of a percentage point over LIBOR for an eight-year $121 million dollar credit, even with a guarantee from the Soviet Ministry of Merchant Marine.

[11]Basis points are hundredths of percentage points. Thus, 25 basis points is one-quarter of one percent.

[12]The flavor of these conversations is captured in comments on Vneshtorgbank's negotiating style reported in "Inside the Soviet Debt Machine," *Euromoney*, January 1987, pp. 46–54.

In the fall of 1989, the climate for Soviet bank borrowing began to change. The centrifugal forces at work in the Soviet Union were manifest in increasingly popular separatist movements, first in the Baltic republics and shortly afterward elsewhere. The inability of the central government to maintain economic and political order was apparent in the ethnic unrest in Azerbaijan and Moldavia and the rail blockade of Armenia by Azerbaijan. In early October, President Gorbachev called for emergency powers to halt strikes and other disruptions of industry and transport, warning that political unrest had brought the Soviet economy to the brink of collapse. He got the powers he wanted and imposed a ban on strikes. The ban was promptly defied by thousands of Siberian coal miners. Economic reform seemed stalled, and in December Gorbachev seemed to admit as much by publicly calling for a slower pace of economic reform. Also at about this time, Western exporters of various goods to the Soviet Union began to encounter sporadic payment delays. Doubts were beginning to grow in the minds of many observers about whether the economic or political preconditions for Soviet creditworthiness any longer existed.

By early 1990, Western banks began to reduce their limits on lending to the Soviet Union. As early as February 1990, the financial press was carrying reports of Soviet debt being sold at discount by Western banks.[13] So sudden and complete was the loss of banking confidence in the Soviet Union that there was no observable deterioration in the terms of syndicated loans to the Soviet Union. There simply were no more unguaranteed syndicated loans. For all practical purposes, bank lending to the Soviet Union on conventional terms dried up in early 1990.[14]

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[13]See, for example, Janet Porter, "Some Banks Offer to Sell Soviet Debt at Discount," *Journal of Commerce*, February 7, 1990.

[14]An indication of how thoroughly the Soviet Union has been cut off from access to bank lending on normal commercial terms was provided by the announcement in January 1991 by Deutsche Bank that it would make no more loans to the Soviet Union without a 100 percent guarantee from the German government. This announcement was particularly significant because Deutsche Bank, Germany's largest bank, had been prominent among Western banks in dealing with the Soviet Union. See, David Marsh and Katharine Campbell, "Soviet Credit Rating to Be Downgraded by Deutsche Bank," *The Financial Times*, January 15, 1991.

GOVERNMENT GUARANTEES FOR BANK LENDING

Since early 1990, Western bank lending to the Soviet Union has been dominated by deals guaranteed or subsidized by Western governments. In June, for example, the German government guaranteed a DM5 billion ($3 billion), twelve-year bank credit to the Soviet Union.[15] In October, work was completed on the first tranche of an additional DM2 billion ($1.3 billion), five-year loan from German commercial banks to VEB. This loan, a part of the larger package of German aid for the repatriation of Soviet soldiers stationed in East Germany, carried a 95 percent German government guarantee. It was also interest-free to the Soviet Union; the German government will pay interest to the lending banks (at a rate of 20 basis points over LIBOR) on the outstanding balance. Under the terms of the German/Soviet agreement on the removal of Soviet troops, an additional interest-free credit of DM1 billion ($0.7 billion) was to be made available by German banks before the fall of 1991.[16]

Also in October 1990, the Italian government agreed to guarantee credits to the Soviet Union totaling L7,200 billion ($6.4 billion) between then and 1994. L2,200 billion of this carries a 90 percent government guarantee and, interestingly, is to be used in part to pay off Soviet arrearages to Italian companies. The remaining L5,000 billion are export credits fully guaranteed by the government's export credit guarantee agency.[17] In November, the Australian government offered to guarantee A$500 million in trade credits, on condition that the Soviet Union first repay outstanding debts to Australian exporters.[18] Finally, there are reports that the Spanish government has offered to guarantee $1 billion in bank credits to the Soviet Union.[19]

Further government-guaranteed bank lending to the Soviet Union was suspended briefly in late 1990 and early 1991, in the wake of the Soviet crackdown on the rebellious Baltic republics. By February

[15]Ferdinand Protzman, "Bonn to Prop Up Kremlin Reforms with $3 Billion Loan Guarantee," *The New York Times*, June 23, 1990. Interestingly, even with German government guarantees, this credit carried a spread of 50 basis points over LIBOR—less favorable terms than the Soviet Union was able to arrange without guarantees just seven months earlier.

[16]Katharine Campbell, "DM2bn Aid for Moscow Prepared," *The Financial Times*, October 12, 1990.

[17]John Wyles, "Italian Loan to Boost Trade with Moscow," *The Financial Times*, October 19, 1990.

[18]"Hawke Offers Moscow Export Credit for Australian Goods," *The Financial Times*, November 21, 1990.

[19]Peter Bruce, "Little Respite in Gorbachev's Spanish Stopover," *The Financial Times*, October 26, 1990.

1991, though, new guaranteed loans had been extended by German and French banks.[20] In March, the Korean government came forward with guarantees for $500 million in bank lending to the Soviet Union, the first lending ever by Korean banks to the Soviet Union.[21] Also in the first half of 1991, the United States government guaranteed some $2.5 billion in bank lending to finance Soviet grain purchases from the United States.

Having lost access to international credit markets on conventional terms, the Soviet Union has been forced to turn to Western governments for credit. Rather than provide the necessary credit directly, these Western governments have typically preferred to use guarantees and interest rate subsidies to encourage commercial banks to extend the credit.

This increase in government guarantees for bank lending to the Soviet Union is a reversal of recent trends (see Table 4.2). In the early 1980s, about a third of all Western bank lending to the Soviet Union was guaranteed by Western governments. The fraction guaranteed fell sharply during 1985 and 1986 and remained at low levels through the end of 1989. The flood of government-guaranteed credits during 1990, though, will almost certainly bring a marked rise in this fraction as these guaranteed credit lines are drawn down during 1991.

CHANGING SYNDICATION PATTERNS FOR SOVIET BANK BORROWING

The late 1980s also saw changes in the ways that syndicated bank loans to the Soviet Union were put together. Before the fall of 1988, syndications typically included banks from a number of Western countries. For the most part, these syndicated loans had little political or national significance. Western governments generally had little to do with whether or not particular banks participated in these syndications, and the funds raised through syndicated loans were generally only loosely tied to particular imports, if they were restricted at all. Beginning in October 1988, though, a number of new, very large syndicated loans to the Soviet Union were arranged, each involving

[20] "France Offers New Credit to Soviet Union," *The Financial Times*, February 13, 1991. "Germany Agrees 900 Million Soviet Union Credit," *Reuters*, February 26, 1991.

[21] *Euromoney Euroweek*, April 19, 199, p. 47. It is interesting to note that even with government guarantees, this loan carried an interest rate of 1.25 percentage points above LIBOR.

Table 4.2

Guaranteed Bank Lending to the Soviet Union (at semester ends)

Semester	Guaranteed Bank Claims ($ billions)	Total Bank Claims ($ billions)	Percent Guaranteed
1982:II	5.6	16.6	34
1983:I	5.8	16.9	34
1983:II	4.9	16.7	29
1984:I	6.1	16.9	36
1984:II	5.7	17.1	33
1985:I	5.7	19.3	30
1985:II	6.4	22.7	28
1986:I	5.4	26.2	21
1986:II	5.1	29.1	17
1987:I	4.8	30.0	16
1987:II	4.7	33.3	14
1988:I	5.4	34.1	16
1988:II	5.9	36.9	16
1989:I	5.1	40.0	13
1989:II	4.9	44.8	11
1990:I	4.4	41.3	11
1990:II	4.7	42.1	11

SOURCE: OECD.

banks from only one country. In most of these cases, the relevant Western government was active in arranging the loans, and in all cases the loans were tied to imports of goods from the country whose banks made up the syndicate.

The first of these nationally syndicated loans (signed on October 14, 1988) provided a credit line of 680 million ECU from Italian banks for the purchase of Italian machinery to be used for the production of consumer goods in the Soviet Union. The syndicate was organized by a state-owned bank, Mediocredito Centrale, and the full amount of the credit was guaranteed by the Italian government's Credit Export Insurance Agency. On October 17, German banks agreed to provide DM3 billion, to finance purchases of German equipment and machinery to upgrade the Soviet consumer goods industry. This loan was not guaranteed by the German government, but government interest in the loan was clearly signaled by the presence at the signing ceremony of German Chancellor Helmut Kohl. A syndicate of British banks was organized around the same time to offer a credit line of between £1 billion and £1.5 billion to help finance Soviet

industrial modernization. This credit was to be guaranteed by the British government's Export Credits Guarantee Department. Ultimately, the British banks and VEB could not come to terms, and negotiations on this credit line came to naught.[22] VEB did subsequently arrange substantial credit lines with a number of individual British banks, however. Credit Lyonnais lead a consortium of French banks in a FF12 billion syndication to support development of a number of Soviet industrial sectors. Although agreement was reached on terms in November 1988, the credit arrangement seems never to have been completed. There were also rumors during the same period that a major Japanese syndication was in the works. Nothing ever came of this, though, and there is some doubt today about whether a Japanese syndication was in fact ever negotiated seriously.

These national syndications came at a time when Western governments, and European governments in particular, were eager to assist the processes of economic and political reform in the Soviet Union. At this time, Western banks were also beginning to reevaluate Soviet economic and political prospects and longer-term creditworthiness. A number of observers suggested at the time that encouragement by Western governments was necessary for these loans to be concluded. With hindsight, we can see in these national syndications the precursors of the large-scale lending guaranteed by Western governments that marked 1990.

These national syndications also may have served to disguise, for a time at least, a worsening of the terms on which the Soviet Union could attract large-scale credits. Western government interest in the loans may have encouraged banks to offer credit on terms that would have been unlikely for purely commercial transactions. Further, credits extended through these national syndications were parts of larger packages that bundled together both export sales of particular products and financing for these sales. This created opportunities for cross subsidies: Soviet importers might overpay somewhat for certain products, receiving in return finer financing terms than they might otherwise have received. The Western exporters who stood to benefit from such transactions may have provided some compensation to the banks involved—perhaps by channeling their own banking business to banks taking part in the syndicate.[23] In financial markets,

[22] Peter Montagnon, "Soviets Abandon Plan to Raise £1 Billion Trade Credit," *The Financial Times*, December 22, 1988.

[23] According to some reports, this overpayment/compensation arrangement was quite explicit. See, for example, Craig Forman, "U.K.-Soviet Talks Collapse on $1.8 Billion Credit Plan," *The Wall Street Journal*, December 23/24, 1988.

confidence sometimes begets confidence, and Soviet financial authorities interested in preserving Soviet access to international credit markets might understandably have wished to preserve the impression that the Soviet Union continued to enjoy such access. The export and financial communities of Western nations, either with or without direct government involvement, might understandably have welcomed opportunities to gain a larger share of the total Soviet market, particularly if this could be done on relatively favorable terms. Thus, all sides to these transactions may have had reasons for participating in what may have amounted to a mild charade.

THE TERM STRUCTURE OF SOVIET BORROWING

Besides keeping track of the total amounts lent by Western banks to the Soviet Union, the BIS also collects information on the term structure of this debt. At the end of 1989, 49 percent of total Soviet debt to Western banks (that is, a bit more than $21 billion) carried maturities of one year or less.[24] During the next six months, though, this share declined, and by the middle of 1990 it stood at just under 42 percent. As we have already noted, Western banks sharply reduced their exposure to the Soviet Union during the second quarter of 1990. They did this, generally, by refusing to "roll over" (to extend new credits to replace) maturing debt. Only a small fraction of Soviet long-term debt became due during this period, but much of the short-term debt did. As a consequence, a large amount of short-term debt was extinguished, and the share of short-term debt in the overall Soviet balance sheet declined.

Despite this recent reduction in short-term debt, the Soviet Union still relies heavily on short-term financing. As of June 1990, Soviet financial managers faced the need either to repay or to replace some $17 billion of bank credit in the next twelve months. This reliance on short-term debt means that the Soviet Union must be constantly in international credit markets and is therefore constantly vulnerable to changes in market sentiment. Even a temporary loss of market confidence could bring a multi-billion-dollar reduction in total credit

[24] *The Maturity and Sectoral Distribution of International Bank Lending*, Bank for International Settlements, Basel, January 1991. This reflected a high, but not unprecedented, degree of dependence on short-term credit for the Soviet Union. At the end of 1981, for example, 50 percent of Soviet liabilities to Western banks carried maturities of less than one year. (The total debt outstanding to Western banks was, of course, much lower then—about $16 billion.) The share of short-term debt declined gradually during the early 1980s, reaching a low of about 41 percent in mid-1987, and then rose again to the 49 percent observed at the end of 1989.

as banks refuse to roll over maturing debt. Debts that are not rolled over must be repaid. If, on some future occasion, the resulting demands for repayment should exceed readily available Soviet hard-currency assets, a classic liquidity crisis could ensue. The shorter the average maturity of Soviet debt, the larger will be the total fraction of this debt that matures during any particular period, and the greater will be the likelihood that a temporary loss of confidence will bring a crisis. For this reason, a principal objective of Soviet international financial policy in recent years has been to find ways to lengthen the maturity of Soviet debt. This is part of the reason for Soviet efforts beginning in 1988 to tap international bond markets. (For more on Soviet bond issues, see Sec. 6.)

THE SOURCES OF BANK LENDING TO THE SOVIET UNION

Although the BIS has information about Soviet assets and liabilities vis-à-vis banks in individual Western countries, it does not make this information public. Publicly released BIS figures show only the aggregate claims of all Western banks on the Soviet Union and total Soviet deposits in all Western banks. The central banks of some Western countries, however, regularly publish information on the foreign assets and liabilities of commercial banks under their jurisdictions. From these national figures, it is possible to piece together at least a partial picture of the geographical distribution of Soviet assets and liabilities vis-à-vis Western banks. Figures 4.3 and 4.4 provide estimates of these positions at years end 1988 and 1989. In both years, banks in five countries (the United Kingdom, France, Germany, Switzerland, and the United States) accounted for almost two-thirds of bank loans outstanding to the Soviet Union. United Kingdom banks—including the U.K. subsidiaries of foreign banks—accounted for the largest share. This is not surprising, given London's position as the principal center for international lending. France's importance is perhaps more puzzling. At the end of 1989, French banks accounted for only about 6 percent of the total foreign assets of all Western banks, but they accounted for more than 17 percent of all Western bank claims on the Soviet Union. German banks will doubtless account for a larger share of all bank claims in future years, as a consequence of the major new lines of credit extended to the Soviet Union in 1990.

The Bank of Japan, the Japanese central bank, does not publish information on the exposure of Japanese commercial banks to foreign

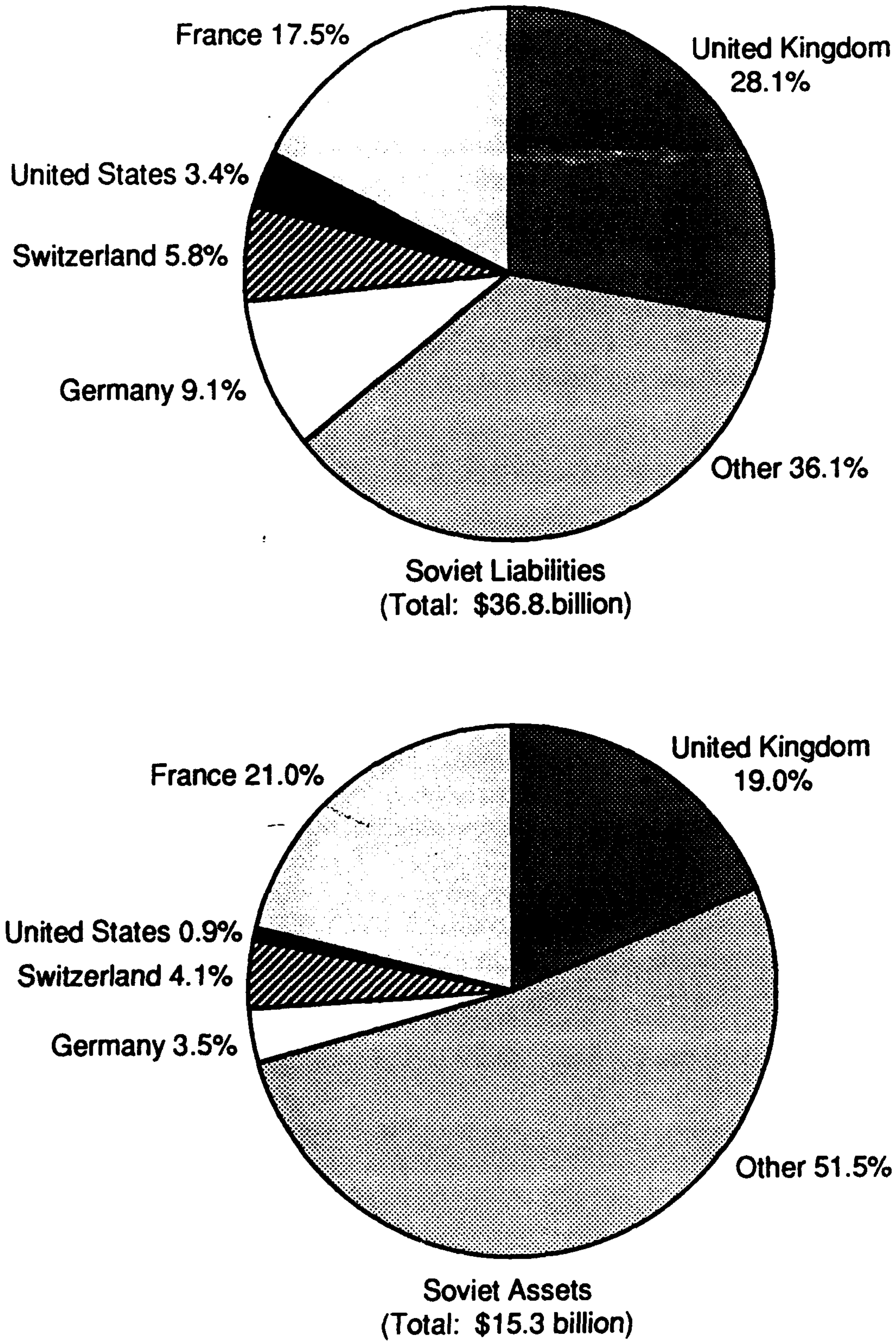

Fig. 4.3—Distribution of Soviet assets and liabilities by country, 1988

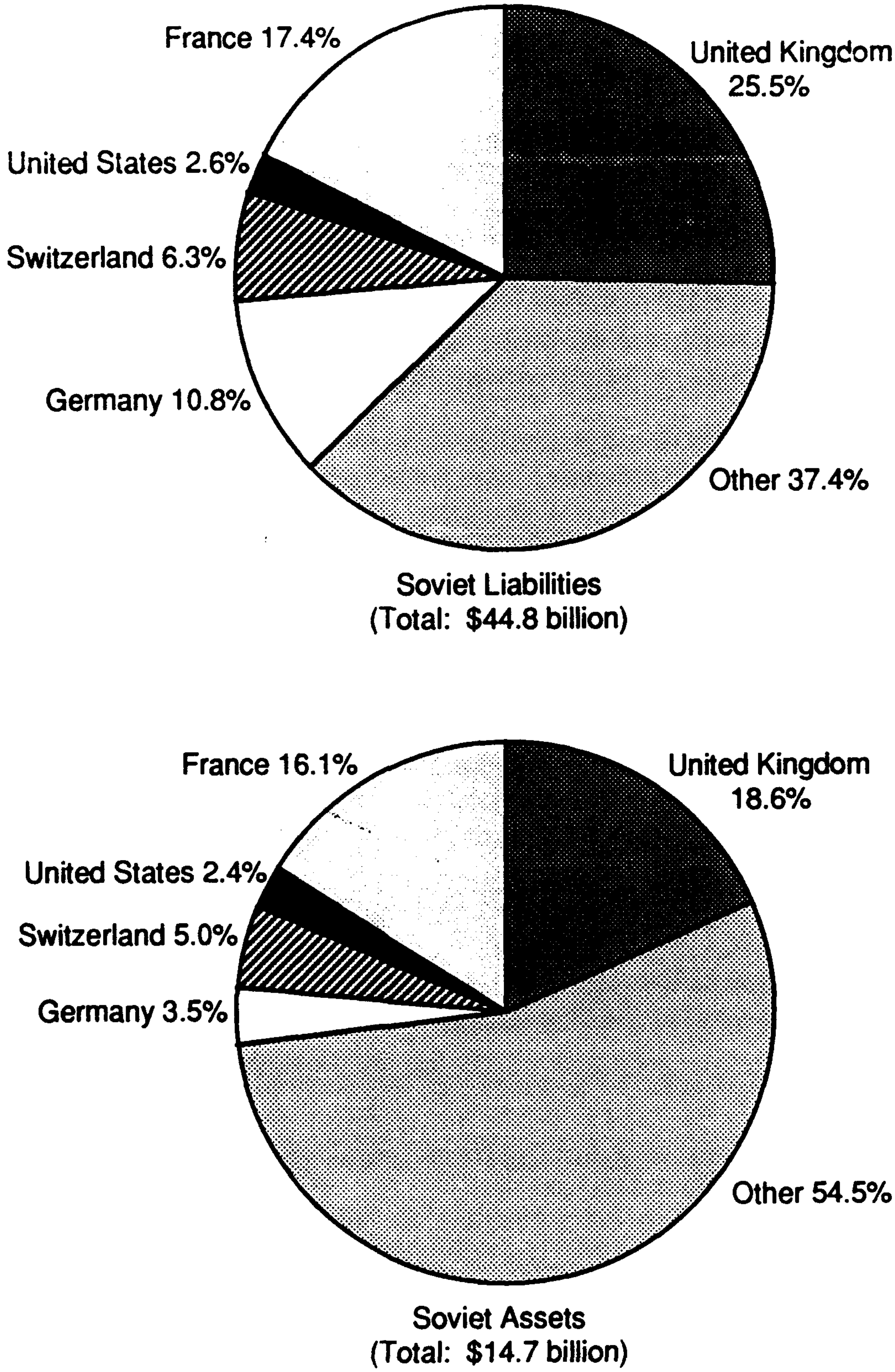

Fig. 4.4—Distribution of Soviet assets and liabilities by country, 1989

borrowers, and thus we do not know what share of total Soviet debt is held by Japanese banks. Because of political differences between the Japanese and Soviet governments over control of the Kurile Islands, Japanese banks have typically assumed a very low profile in dealings with the Soviet Union.[25] Japanese banks have not opened representative offices in the Soviet Union (as have major banks from other countries), and Japanese banks are seldom among the leaders of syndicates on Soviet loans. Nonetheless, there are indications that Japanese banks have been substantial lenders to the Soviet Union. Using a one-time estimate by the Japan Bond Research Institute, Robert McCauley and Edward Trickey of the Federal Reserve Bank of New York calculate that in June 1987, Japanese banks accounted for one-quarter (or about $7.5 billion) of all foreign bank lending to the Soviet Union.[26] No confirmation of these figures is possible, and the estimate seems improbably high. If the figures are correct, Japan was the principal source of foreign bank credit to the Soviet Union in 1987.[27]

Soviet hard-currency deposits are apparently less concentrated geographically than Soviet liabilities. The same five countries that account for two-thirds of all lending to the Soviet Union hold less than half of all Soviet hard-currency deposits. At the end of 1989, U.K. banks accounted for the largest identified share of these deposits, with French banks close behind. Notice, though, that these positions were reversed a year earlier.

U.S. BANK DEALINGS WITH THE SOVIET UNION

As Figures 4.3 and 4.4 suggest, U.S. banks as a group are neither major lenders to nor major takers of deposits from the Soviet Union. Neither have U.S. banks typically led syndications of loans to the Soviet Union.[28] Figure 4.5 shows U.S. bank claims on and liabilities

[25]Japanese sensitivity on this point is illustrated by the following anecdote. Recently, a group of commercial bankers from a number of countries visited Moscow to discuss the economic situation with Soviet officials. A representative of a major Japanese bank asked that his name be omitted from the report subsequently issued by the delegation, preferring not to tie his bank too closely with the Soviet Union.

[26]Robert N. McCauley and R. Edward Trickey, *Perestroika and International Financial Markets,* Federal Reserve Bank of New York Working Paper, January 1990, p. 17.

[27]It is possible that this estimate is inflated by the inclusion of foreign branches and subsidiaries of Japanese banks.

[28]An exception to this general rule is the First National Bank of Chicago, which has been active in Soviet loan syndications. On at least two occasions, it has led such syn-

to the Soviet Union in recent years. Before late 1988, both were quite small. Banks claims on the Soviet Union were generally less than $500 million. Except for a few isolated months, liabilities to the Soviet Union remained below $200 million.[29] Near the end of 1988, U.S. bank claims on the Soviet Union expanded significantly—into the $1.5 billion dollar range. In early 1990, though, claims subsided toward more traditional levels, perhaps as U.S. banks—like banks elsewhere—reassessed Soviet creditworthiness. Throughout 1989 and early 1990, there was also some modest expansion of Soviet deposits in U.S. banks. The level of these deposits became sufficiently volatile, though, that it is hard to identify any clear trend.

U.S. banks are constrained in their dealings with the Soviet Union by the terms of the Johnson Debt Default Act of 1934. This act makes it "unlawful within the United States . . . for any person to purchase or sell the bonds, securities, or other obligations of any foreign government . . . or to make any loan to such a foreign government . . . while such government . . . is in default in the payment of its obligations . . . to the Government of the United States." The act applies to the Soviet Union because the U.S. government considers the Soviet Union to be in default on some $193 million (more than $900 million, counting accrued interest) of debt incurred by the pre-Bolshevik Karenski government. Successor Soviet regimes have refused to recognize this debt.[30]

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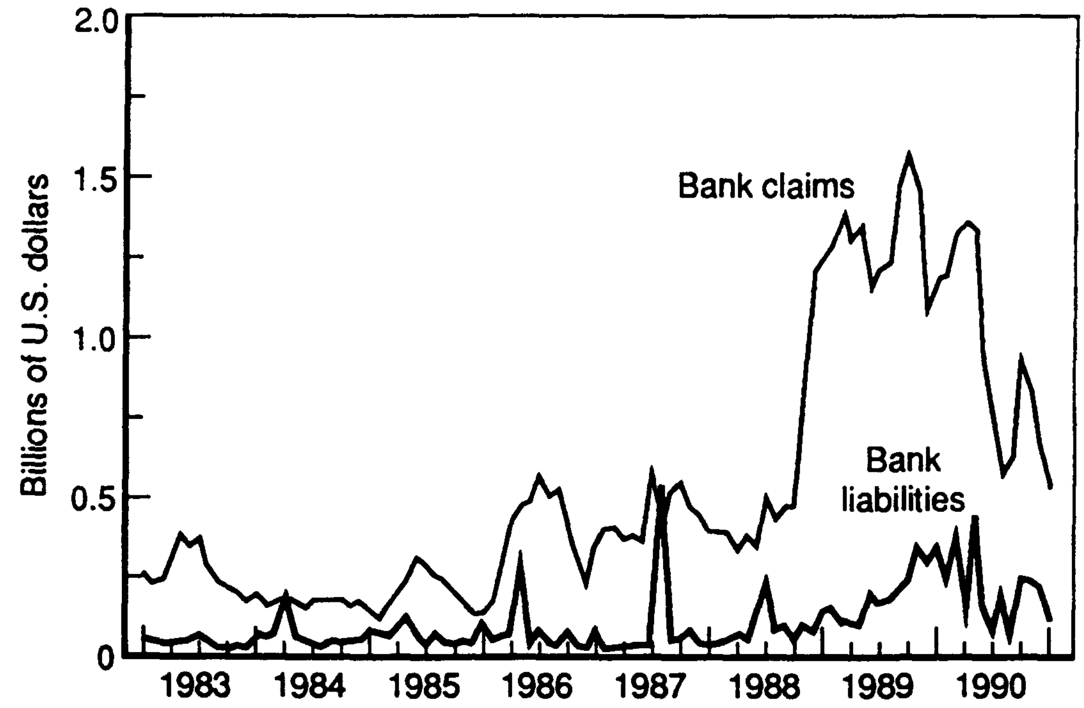
dicates. The lead managers of a syndication handle much of the negotiation and the paperwork for a loan, and for this effort they collect fees from the borrower. The funds for the loan, however, are typically provided by the many banks that participate in the syndication. The exposure of any single lead manager is usually a small fraction of the total value of the loan.

[29]The one-month spikes in U.S. bank liabilities to the Soviet Union (in, for example, March 1984, April 1986, and July 1987) do not appear to reflect reporting errors. Multiple issues of the *Federal Reserve Bulletin* repeat these figures. Apparently, large cash balances are sometimes present in Soviet accounts at the end of the month. These balances probably reflect temporary cash balances associated with the drawing down of bank loans or funds deposited temporarily in preparation for a major payment.

[30]The Soviet Union also has outstanding debts to the U.S. government arising from the World War II Lend Lease program. The Soviet government recognizes these debts, and although the debts are not being serviced the Soviet Union is not technically in default. A 1972 agreement between the Soviet Union and the United States established a schedule for Soviet payments on these debts, contingent on the Soviet Union being granted most-favored-nation status by the United States. The Jackson-Vanik Amendment to the Trade Act of 1974, however, requires that "products from any nonmarket economy shall not be eligible to receive nondiscriminatory treatment (most-favored-nation treatment) . . . . [if] the President determines that such country denies its citizens the right or opportunity to emigrate." Successive presidents have determined that the Soviet Union does in fact restrict emigration, and therefore the Soviet Union cannot be granted most-favored-nation status. Consequently, no payments are due on the Soviet Lend Lease debt, and the Soviet Union is not in default.



SOURCE: U.S. Federal Reserve.

Fig. 4.5—Claims and liabilities of U.S. banks vis-à-vis the Soviet Union

Given the apparently blanket prohibition in the Johnson Debt Default Act, it may be surprising that there is any lending at all to the Soviet Union by U.S. banks. In a number of opinions, though, U.S. Attorneys General have ruled that trade-related banking activities, including trade-related credits, are permissible. Further, the act does not apply to foreign branches or subsidiaries of U.S. banks.[31] Potentially more important, the Bretton Woods Agreement Act of 1945 (the legislation that authorized U.S. membership in the International Monetary Fund) supersedes the Johnson Debt Default Act and removes the earlier act's prohibitions on lending to any country that is a member of the IMF. The Soviet Union has expressed interest in becoming a member of the IMF. If and when this happens, all restrictions on U.S. commercial bank lending to the Soviet Union will be removed.

[31]*Report of the Special Interagency Task Force on Western Lending to the Soviet Bloc, Vietnam, Libya, Cuba, and Nicaragua*, November 1988, p. 5. Lending to the Soviet Union by foreign branches of U.S. banks is not reflected in Fig. 4.5.

THE CHARACTER OF SOVIET HARD-CURRENCY ASSETS

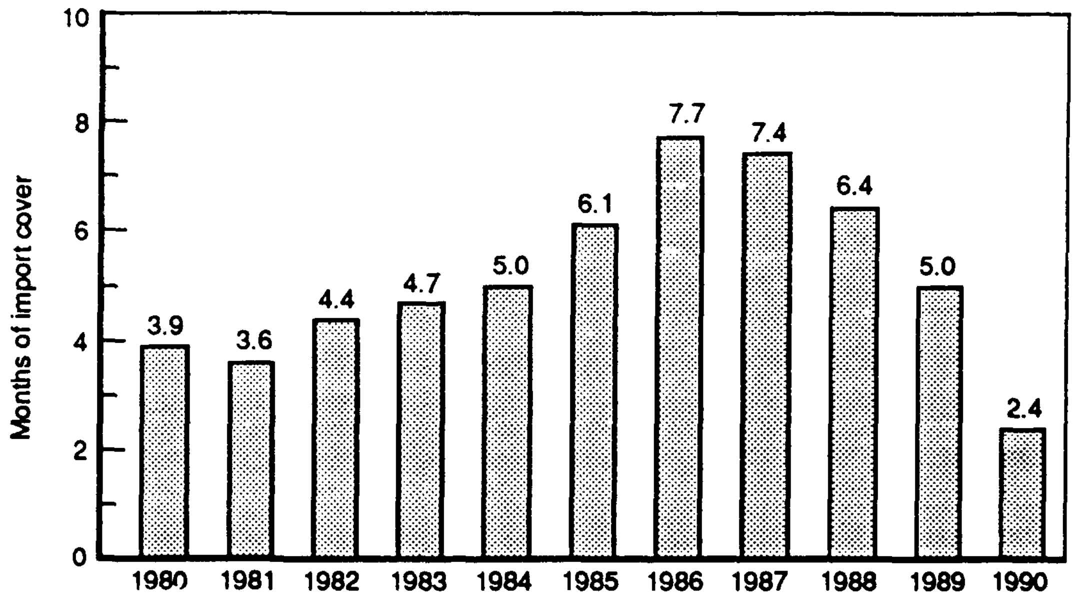
The Soviet assets reported in the BIS statistics are all in the form of deposits in BIS-reporting banks. Discussions with bankers and other observers of Soviet financial activities suggest that these deposits are almost exclusively of short maturities. Apparently, maturities of more than six months are rare, and a large fraction of these deposits is accounted for by overnight deposits. In this regard, Soviet financial practice has not changed in recent years. Soviet financial managers have traditionally adhered to very conservative asset management strategies, concentrating their holdings in short-term bank accounts.

Discussions with Western bankers suggest and conversations with Soviet financial officials confirm that, at least as of mid-1990, all deposits in Western banks are held in the name of VEB. There is some confusion over whether other entities—ministries, foreign trade organizations, or enterprises, for example—are permitted to hold foreign currency assets. Although legislation allowing such holdings has been passed, no entity other than VEB seems yet to have taken advantage of this new freedom.

Soviet holdings of hard currency have traditionally been substantial, given the limited extent of Soviet hard-currency international transactions. Figure 4.6 shows the levels of these deposits at year end, expressed in terms of how many months of Soviet hard-currency merchandise imports they would buy. Surging import spending and the rapid drawing down of bank deposits since the middle of 1989 have sharply reduced Soviet import curves. Before 1990, though, Soviet hard-currency holdings were nonetheless quite large relative to the official foreign exchange reserve holdings of other countries (see Table 4.3). Only Spain and Taiwan matched or exceeded the Soviet peaks of import cover.[32] The level of Soviet foreign currency reserves in the past was all the more remarkable in view of the fact that the ruble is not convertible. For countries with convertible currencies, reserves are sometimes required for intervention in foreign exchange markets. The Soviet Union, of course, needs no foreign currencies for this purpose.

Maintaining large hard-currency balances on deposit in Western banks has been costly for the Soviet Union. Because these deposits

[32]The intent in Table 4.3 is to provide a comparison of the foreign-currency funds that are at the disposal of national financial authorities. Private entities of most of the countries listed in the table maintain additional foreign-currency bank balances. These balances are typically not available for use by financial authorities. In the Soviet Union, however, all foreign-currency balances are controlled by national authorities.



SOURCES: CIA and BIS.

Fig. 4.6—Soviet hard-currency deposits

Table 4.3

Official Reserve Holdings for Selected Countries (year end 1989)

	Millions of U.S. $		
Country	Reserves[a]	Merchandise Imports	Months of Import Cover
Taiwan	73.2	52.5	16.7
Spain	41.5	61.5	7.0
Venezuela	4.1	8.7	5.6
Japan	84.0	209.7	4.8
Thailand	9.5	25.1	4.5
Brazil	7.5	20.0	4.5
Indonesia	5.5	16.6	3.9
China	18.0	58.3	3.7
Turkey	4.8	15.8	3.6
Mexico	6.3	24.4	3.1
Korea	15.2	61.3	3.0
Austria	8.6	39.0	2.6
Germany	60.7	269.7	2.7
Poland	2.3	10.5	2.7
India	3.9	20.4	2.3
United Kingdom	34.8	197.7	2.1
Canada	16.1	119.8	1.6
France	24.6	193.0	1.5
United States	63.6	492.9	1.5

SOURCE: IMF.

[a]Total foreign exchange holdings, excluding gold.

typically have very short maturities, they earn relatively low interest rates—typically near LIBOR. As we have seen, Soviet debt typically carries higher interest rates. By liquidating bank balances to pay down outstanding loans, the Soviet Union could save some hard currency. Why, then, has the Soviet Union maintained such large balances?

Large Soviet deposits apparently do not reflect demands by Western banks for compensating deposit balances as a condition for lending to the Soviet Union. Compensating balances are no longer a typical feature of international lending in general, and they do not seem to have been required of the Soviet Union in recent years.

Some observers have suggested that large Soviet holdings of foreign currency reflect inefficient, decentralized cash management by the Soviet Union. Rather than being a unified pool of funds, this argument goes, Soviet deposits reflect the holdings of numerous ministries, bureaus, and trading organizations. Without an efficient internal money market, excess funds held by one entity might not be made available for the temporary use of another entity. The result would be higher overall balances as each financial entity sought to hold reserves adequate to its own needs.

Although recent reforms have given at least nominal control of hard currency balances to ministries and enterprises, all Soviet deposits in Western banks are still held (and, one presumes, controlled) by VEB. Some inefficiency in the use of hard-currency balances may appear in the future, but it seems unlikely that such inefficiency explains much of past behavior. Curiously, it is precisely in the last two years, when control over foreign currency holdings seems to be becoming less centralized, that the level of hard-currency deposits is falling.

A more likely explanation for why the Soviet Union has held such large foreign currency reserves is that Soviet reserves have had to do double duty. For all countries, foreign-currency reserves provide a hedge against economic uncertainty. They provide a store of international purchasing power that can be drawn on in the event of an unexpected shortfall in export revenues or an unforeseen rise in import requirements. For the Soviet Union, however, hard-currency reserves have also provided a measure of protection against political uncertainty. The vagaries of East/West political relations might on some occasions have impeded Soviet access to international credit markets, and it would therefore have been prudent for Soviet financial authorities to "stockpile" hard currencies against the day when they might not have been easily raised. By way of contrast, note in

Table 4.3 the very low levels of international reserves maintained by the United States and Canada. Rather than maintaining large reserves, both of these countries rely on their ability to raise foreign currencies in international credit markets if the need should arise.

Whether the Soviet need for hard-currency reserves has declined as a consequence of recent geopolitical developments is open to question. Certainly, recent reductions in East/West tensions have reduced the political uncertainty surrounding Soviet access to international financial markets. Similarly, membership of the Soviet Union in the IMF—if it happens—will provide access to an additional source of hard-currency funds. At the same time, though, Soviet economic difficulties and growing uncertainty about the internal political situation have caused many Western lenders to back off from their earlier willingness to lend to the Soviet Union. The resulting increased Soviet dependence on official and officially guaranteed lending has introduced a new political dimension into questions of Soviet access to foreign credit. Western governments can no longer stand aloof from the "purely business" decisions made by private banks regarding lending to the Soviet Union. Now, lending to the Soviet Union requires that these governments commit their taxpayers' money—either directly or contingently—and the question of whether or not to lend becomes a matter of public policy. Inevitably, these public policy decisions will be influenced by political developments in the Soviet Union. Ironically, it may be that internal political uncertainty now threatens Soviet access to Western credit markets just as much as international political uncertainty did in earlier years and that Soviet needs for a hard-currency "stockpile" is just as great as it ever was.

Considerations of this sort suggest a final and perhaps the most important motivation for large Soviet foreign exchange holdings. Large foreign exchange holdings may reflect a Soviet desire to be seen as obviously creditworthy. By maintaining large and highly visible hard-currency deposits, the Soviet Union could in the past reassure lenders that debt-servicing problems were unlikely. This no doubt improved the Soviet bargaining position when dealing with potential lenders and emphasized Soviet independence from any particular Western lender. As the Soviet economic situation has deteriorated, lenders have become more wary, forcing the Soviet Union to draw down its hard-currency deposits, thus making lenders even more wary. This kind of self-reinforcing process may partially explain the very rapid deterioration of Soviet access to Western financial markets that we saw in 1990.

Missing from the BIS accounting are Soviet claims on nonbanks in the West. In concept, these unreported assets could include Soviet holdings of government or corporate bonds, trade-related advances to foreign importers of Soviet goods, or equity stakes in Western firms. Deposits in banks that do not report to the BIS would also be missing. Also missing from this accounting are Soviet hard-currency claims on developing countries. These claims arise primarily from past Soviet aid activities, and most observers consider them to be uncollectable. We discuss these claims in Sec. 7. It suffices to point out here that, although the Soviet Union has apparently acquired some foreign government bonds in recent years, most observers agree that the deposits in Western banks reported by the BIS represent very nearly all usable Soviet hard-currency assets.

5. SOVIET DEBT TO OFFICIAL EXPORT CREDIT AGENCIES

Most industrialized countries have created government agencies to assist in providing credit to foreign purchasers of their exported goods. Sometimes this assistance is in the form of direct loans by government agencies to foreign purchasers. Interest rates on these official loans are typically below the interest rates importers could negotiate on a loan from a private lender. Official support of export credit can also take the form of government guarantees that a private lender will be repaid if he lends money to finance exports. With such a guarantee, a private lender might offer a lower interest rate than he would if the loan were not guaranteed.

Two agencies of the U.S. government, the Export-Import Bank and the Commodities Credit Corporation, extend and guarantee export credits.[1] The Jackson-Vanik Amendment to the Trade Act of 1974 prohibited either of these institutions from making or guaranteeing loans to the Soviet Union as long as the U.S. President determined that Soviet citizens were not free to emigrate.[2] The governments of other Western countries, however, have continued to make credit available to the Soviet Union through their official export credit agencies. After commercial banks, these official export credit agencies have been the most important source of Western credit to the Soviet Union. As we have already seen, 1990 saw a dramatic rise in the guarantee activities of these agencies with regard to bank loans to the Soviet Union.

Since 1982, OECD has published semiannual reports of the official and officially guaranteed trade-related credit extended by OECD member countries.[3] Table 5.1 shows the amounts of official and

[1] A third agency, the Oversees Private Investment Corporation (OPIC), makes loans to U.S. firms investing abroad and guarantees the foreign investments of U.S. firms, but only against political risk (i.e., expropriation, revolution, investment, currency inconvertibility, etc.).

[2] In December 1990, President Bush exercised his authority under the terms of the Jackson-Vanik Amendment to waive temporarily this prohibition to allow the Commodities Credit Corporation to finance agricultural exports to the Soviet Union.

[3] Essentially all of the Western industrialized nations are members of the OECD. The 24 members of the OECD are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Turkey, the United Kingdom, and the United States. Twenty-two of these countries report their official and officially guaranteed trade credits to the OECD. The two countries that do not are Iceland and Turkey.

officially guaranteed credits outstanding to the Soviet Union in the past several years. Throughout most of the period covered by the table, the value of official credits to the Soviet Union has been declining, as has been the share of Soviet gross debt held or guaranteed by Western governments. This pattern will likely change, though, in 1991 as the large new lines of official and officially guaranteed credit made available to the Soviet Union during 1990 and early 1991 are

Table 5.1

Official and Officially Guaranteed Credit to the Soviet Union (in billions of U.S. dollars at semester ends)

Semester	Trade-Related Official Claims	Officially Guaranteed Bank Claims	Total Official and Officially Guaranteed Credits	Percentage of Soviet Gross Debt Held or Guaranteed by Western Governments[a]
1982:II	12.0	5.6	17.6	62
1983:I	11.8	5.8	17.7	61
1983:II	10.2	4.9	15.1	56
1984:I	9.4	6.1	15.5	59
1984:II	8.5	5.7	14.2	55
1985:I	8.2	5.7	14.0	51
1985:II	8.6	6.4	15.0	48
1986:I	8.6	5.4	13.9	40
1986:II	8.4	5.1	13.5	36
1987:I	7.3	4.8	12.2	33
1987:II	6.9	4.7	11.6	29
1988:I	5.0	5.4	10.4	27
1988:II	4.9	5.9	10.8	26
1989:I	5.6	5.1	10.7	23
1989:II	5.4	4.9	10.3	21
1990:I	6.9	4.3	11.3	24
1990:II	5.9	4.7	10.6	22

SOURCES: *Statistics on External Indebtedness: Bank and Trade-Related Non-Bank External Claims on Individual Borrowing Countries and Territories*, Bank for International Settlements, Basel, and Organization for Economic Cooperation and Development, Paris, various issues.

[a]In this table, gross Soviet debt is calculated as the sum of Western bank claims and official government claims on the Soviet Union. Excluded are claims of nongovernment, nonbank entities. During most of the period covered by this table, these excluded claims were negligible.

drawn upon.[4] At the end of 1990, *The Financial Times* estimated that the German government alone had guaranteed a potential total of DM19 billion (almost $13 billion) in credits to the Soviet Union.[5]

The decline in official lending to the Soviet Union that characterized most of the 1980s may have reflected changing policies of Western official export financing agencies. More likely, though, it reflected the fact that during most of this period the Soviet Union found it more attractive to raise funds in commercial markets. As we have seen, during this period the Soviet Union enjoyed ready access to commercial credit on very favorable terms. At the same time, terms available from official credit agencies were becoming less attractive.

This latter development stemmed from a 1978 agreement among the member countries of the OECD. Formally, this is known as the Arrangement on Guidelines for Officially Supported Export Credits. Less formally, it is known as the OECD "Gentlemen's Agreement."[6] The agreement was intended to limit what was seen as counterproductive competition among the various official export credit agencies in offering attractive financing to encourage their own countries' exports. The agreement specifies "consensus" minimum interest rates, allowable maturities, down payment requirements, and grace periods for official trade-related lending. It is a gentlemen's agreement in the sense that no enforcement mechanisms are provided. Indeed, the agreement does not actually prohibit loans that do not meet the agreed-upon guidelines. It merely requires a country about to make a noncomplying loan to notify the other parties to the agreement.

For the purposes of the agreement, borrowing countries are grouped into three categories on the basis of per capita income. The agreement guidelines provide finer terms for poorer countries than for

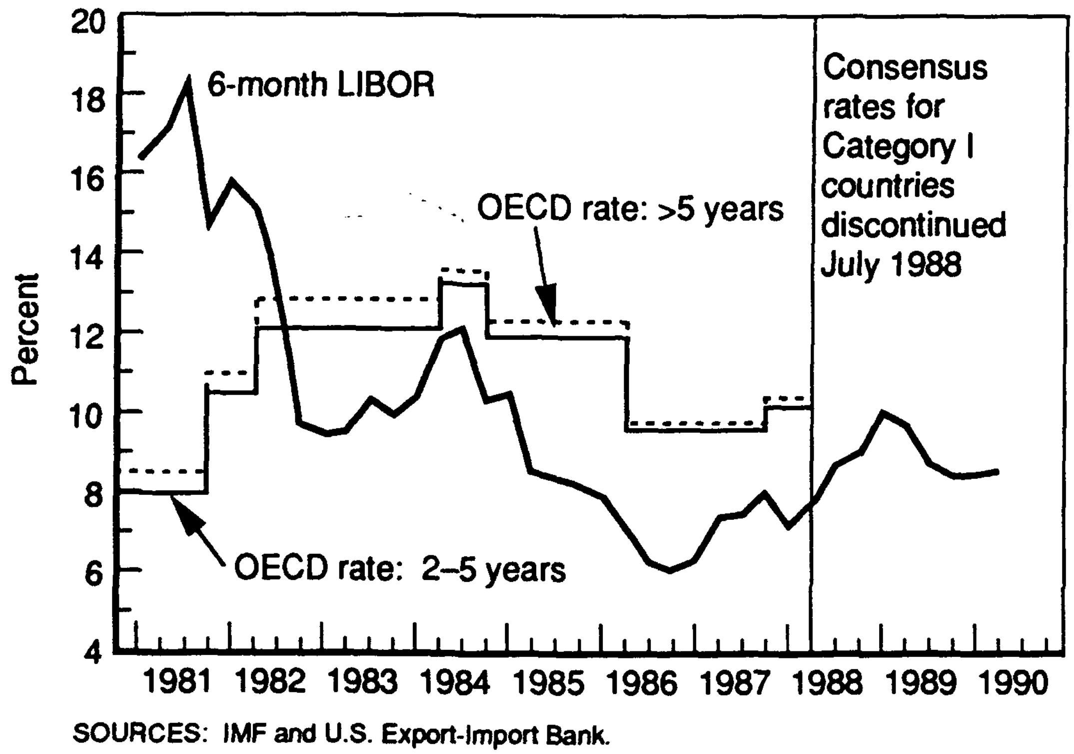
[4]As was the case with the figures on outstanding Soviet debt to Western banks, the figures in Table 5.1 give a somewhat distorted picture of changes in official credit to the Soviet Union. Typically, official export credits are denominated in the currency of the lending country. Since the United States has not extended official credit to the Soviet Union since 1974, few of these official claims are in dollars. Thus, changes in exchange rates can change the dollar value of credits outstanding even if there has been no activity in the underlying accounts. Adjusting the figures in Table 5.1 for changes in exchange rates does not result in any significant change in the general pattern. Through 1989, Soviet reliance on official credit had been declining.

[5]David Marsh, "Moscow in Talks on German Credits," *The Financial Times*, December 27, 1990.

[6]For a discussion of this agreement, see Daniel F. Kohler and Peter H. Reuter, *Honor Among Nations: Enforcing the Gentlemen's Agreement on Export Credits*, RAND, N-2536-USDP, December 1986.

richer ones. The Soviet Union was originally assigned to Category II (medium-income countries). In 1982, however, at the urging of the United States, the Soviet Union was reclassified as a Category I (relatively high-income) country.

Figure 5.1 shows the OECD consensus interest rates that have applied to the Soviet Union since the early 1980s. Also shown is the six-month dollar LIBOR rate, which serves as an index for most private bank lending to the Soviet Union. As we noted in Table 3.2, from 1982 through 1989, the Soviet Union was able to borrow from commercial lenders at less than one percentage point above LIBOR, and for most of this period at only about a quarter of a percentage point above LIBOR. Thus, as the OECD consensus rates rose in 1982 and LIBOR fell, commercial lending became more attractive than official lending. Official export lending practice does not always conform to the term of the Gentlemen's Agreement, of course. But after 1981 it appears that the terms of official lending to the Soviet Union did become more stringent, and presumably discouraged Soviet borrowing from official sources.



SOURCES: IMF and U.S. Export-Import Bank.

Fig. 5.1—Six-month LIBOR and OECD consensus rates applicable to the Soviet Union

In July 1988, consensus rates were discontinued for Category I borrowers and replaced by so-called Commercial Interest Reference Rates. These were closely tied to prevailing commercial interest rates.[7] Commercial loans might still have been more attractive to the Soviet Union—as long as they were available—because commercial loans were politically simpler. Nonetheless, it was just about this time that the level of official loans stopped declining. Perhaps official lending was beginning to appear attractive again.

[7]Part of the motivation for this change in policy was to allow loans denominated in different currencies to carry different interest rates. Under the old system of consensus rates, low-interest-rate countries (Japan and Germany, for example) were disadvantaged in their efforts to offer attractive credit terms to foreign borrowers. Rather than lending at the lower interest rates prevailing in their own markets, they were forced to lend at the higher consensus rates.

6. SOVIET INTERNATIONAL BOND ISSUES

In January 1988, the Soviet Union issued its first-ever international bond[1]—a SFr100 million issue in the Zurich market. Seven more international bond issues have followed: four in the deutsche mark market and one each in the Dutch guilder, Italian lira, and Austrian schilling markets.[2] Table 6.1 details these bond issues. At the end of 1990, the face value of all Soviet bonds outstanding was $1.9 billion.[3] All of these bonds were so-called "straight" issues, that is, the interest rate is fixed for the life of the bonds. In all cases, the official issuer of the bonds was Vneshekonombank.[4]

Most financial market observers were not surprised by the fact of a Soviet bond issue. That such an issue was in the works had been rumored since at least early in 1986. This speculation was fueled by an agreement in July 1986 between Soviet and British financial authorities to settle outstanding claims dating from the 1917 revolution. At issue were czarist bonds that the Soviet government had refused to honor and claims by Britons for compensation for property seized during the revolution. For its part, the Soviet Union sought the return of czarist financial assets frozen in London since the revolution.[5] Previously, the Bank of England had refused permission for bond issues in the London market by the Soviet government (although Moscow Narodny Bank had been allowed to issue notes), usually citing as its reason the unresolved disputes. At the time, the

[1]Generally, a bond is termed "international" if the issuer is not resident in the country where the bond is issued. Strictly speaking, "eurobonds" are bonds denominated in a currency other than the currency of the country where they are issued. (A dollar-denominated bond floated in London, say, would be a eurobond.) In common usage, though, the two phrases are often used interchangeably. One sometimes sees references to "Soviet eurobonds," even though all Soviet bond issues to date have been denominated in the currency of the country in which they were issued.

[2]The Austrian schilling issue in August 1989 was the first schilling bond ever floated by a foreign borrower. This is one of the few examples of pioneering financial activity by the Soviet Union. The most noteworthy previous example was Soviet participation in the newly created Eurodollar markets in London and Paris in the 1950s.

[3]The dollar value of these bonds fluctuates, of course, with exchange rate changes.

[4]Consistent with the Soviet position regarding bank loans to Vneshekonombank, Soviet financial authorities have stressed on a number of occasions that bonds issued by Vneshekonombank carry no state guarantee. See, for example, Andrew Freeman, "Soviet Bank Brings a Whiff of Glasnost to London," *The Financial Times*, November 13, 1989.

[5]For further details, see Craig Forman, "Soviets, British Reach Accord on Czarist Debt," *Wall Street Journal*, July 16, 1986.

Table 6.1
Soviet Bond Issues

Date	Amount	Term (years)	Coupon (%)	Price	Fees (%)	Cost[a] (%)	Lead Underwriters
January 1988	SFr100 million ($74 million)	10	5	101.3	2.875	5.21	Bank fur Kredit und Aussenhandel
July 1988	DM500 million ($271 million)	7	6.375	100	2.25	6.79	Dresdner Bank Deutsche Bank Commerzbank Westdeutsche Landesbank
February 1989	Lit 75 billion ($55 million)	5	12.25	101.875	1.875	12.07	Banco di Roma Banca Commerciale Italiana Banco di Napoli Banca Nazionale di Lavorro Generale Bank Istituto Bancario San Paolo di Torino Shearson Lehman Hutton International
March 1989	DM750 million ($401 million)	7	7	100.25	2.25	7.38	Deutsche Bank Commerzbank Westdeutsche Landesbank Dresdner Bank
May 1989	Fl250 million ($114 million)	7	8	101.5	1.875	8.07	Algemene Bank Nederland Rabobank
August 1989	Sch1 billion ($74 million)	6	8	100.125	1.95	8.40	Creditanstalt Bankverein
September 1989	DM500 million ($256 million)	7	7.5	100.25	2.25	7.88	Commerzbank Westdeutsche Landesbank Dresdner Bank Deutsche Bank
January 1990	DM500 million ($296 million)	5	8.875	100	2.00	9.39	Westdeutsche Landesbank Commerzbank Dresdner Bank Deutsche Bank

[a]Interest cost to borrower including total fees.

agreement was widely seen as clearing the way for a Soviet issue. The Bank of England did nothing to discourage such speculation.

It was, therefore, a bit of a surprise that the first Soviet bond was floated in the Zurich market. London is the center of international bond activity and usually considered the market in which it is easiest for an unfamiliar "name" to make an international debut. Also surprising was the fact that the lead underwriter for the original Swiss franc bond was not one of the major Swiss banks that enjoy a near monopoly on Swiss franc bond issues but the relatively unknown (at least in the international bond market) Swiss subsidiary of a German bank.

The nature of the prospectus that accompanied this first Soviet bond issue was also curious. This prospectus was widely derided (some observers went so far as to call it a "joke") because it provided almost no information on the international financial status of the Soviet Union. It gave rublé figures for VEB's total assets and liabilities but said nothing about its hard-currency assets or liabilities. Historical figures were provided on gross social product, growth rates of industrial production, oil and gas reserves, the state budget, and merchandise trade. Nothing was said, though, concerning Soviet gold sales or gold stocks. Neither were specific numbers quoted on gross or net foreign debt or debt-servicing obligations, usually the most important statistics for assessing international creditworthiness. The only statement in the entire prospectus regarding external debt was: "The USSR has paid when due the full currency face amount of principal (including required amortization) and interest on every external obligation issued by it, or in respect of which it has been required to implement its guarantee."[6] Prospectuses for subsequent bond issues have provided little additional information.

The small size of the first Soviet bond issue and its unusual underwriting team mark this issue as a cautious test of market reception for Soviet bonds. Apparently, Soviet authorities were pleased with the results of the issue, because it was followed six months later by a substantial (DM500 million) issue in the Frankfurt market with the three largest German banks (Deutsche Bank, Dresdner Bank, and

[6]Around the time of the issue, there were rumors that a more complete and more traditional prospectus had been prepared and had even been circulated to a small circle of financial market participants and financial journalists. According to these rumors, this more detailed prospectus did in fact give figures on such sensitive subjects as gold sales and gold production, but was hastily withdrawn. I have been unable to confirm these rumors or to discover anything other than second-hand sources for the existence of the alternative prospectus.

Commerzbank) among the lead underwriters. At the time of this first DM issue, much was made over the fact that the Soviet bond carried a coupon rate lower than the coupon rate on bonds of similar maturity issued by the German federal government. This apparently anomalous result was a reflection of the fact that at the time a withholding tax was applied to domestic DM bond issues but not to foreign issues. Adjusted for taxes, the Soviet Union did not enjoy finer terms than the German government.

The terms on the early Soviet bond issues were, nonetheless, attractive. They marked the Soviet bonds as solidly investment-quality paper, if not in the very top rank of international bonds (like those issued, for example, by the World Bank or the governments of Sweden, France, or Denmark). There is some question, though, about whether these terms reflected true market assessments of Soviet creditworthiness. Underwriting banks typically do not disclose what fraction of a bond issue they succeed in selling to nonaffiliated investors and what fraction they keep for their own portfolios. The market talk concerning the Soviet bond issues is that the underwriting banks kept most of the issues themselves. The banks, of course, will not confirm this, but neither have any strenuously denied it. In private, Soviet financial officials admit that they, too, believe that most of the bonds are still in the hands of the underwriting banks. If the banks had tried to sell a larger share of the issues, prices might have been forced. Thus, it might be that the publicly announced terms overstate market assessments of the quality of Soviet bonds.

There is some reason to think that the underwriting banks never really intended to sell many of the Soviet bonds. The quite perfunctory prospectuses accompanying these bond issues could certainly not have been expected to instill confidence in potential buyers. Further, the underwriting banks received unusually high fees for handling the Soviet issues. On the four DM issues, for example, the fees ranged from 2 to 2.25 percent of the total value of the issue. Fees for established international issuers in this market are usually in the 1.5 to 1.75 percent range. The underwriting banks, it seems, were demanding extra compensation for their role in bringing the Soviet bonds to market. In part, this may simply reflect the fact that more work is involved in introducing an issuer to a market than in placing the bonds of established issuers. Also, because the appropriate pricing of an issue is inherently more uncertain for a new name in the market than for an established name, the underwriters may have sought some compensation for the additional risk they would have to bear. But it is also possible that the higher fees simply reflected the fact

that the underwriters expected from the outset to have to retain a large share of the issues.[7]

The favorable terms that the Soviet Union enjoyed in its early bond issues deteriorated somewhat with subsequent issues. Robert McCauley and Edward Trickey at the Federal Reserve Bank of New York have used interest-rate swap rates[8] to convert the interest costs to the Soviet Union on each of these bonds into equivalent rates for floating-rate DM loans.[9] (This allows bond interest rates to be compared with interest rates on bank loans.) Table 6.2 shows that interest costs on the first two Soviet DM bonds were equivalent to about one-quarter of a percentage point over DM LIBOR, a very attractive spread and similar to what the Soviet Union was paying on bank loans at the time. By the fall of 1989, though, the equivalent spread over DM LIBOR had widened considerably, and by January of 1990, the Soviet Union was paying close to three-quarters of a percentage point over LIBOR.

Table 6.2

Equivalent Floating Interest Rates on Soviet DM Bond Issues

Date of Bond Issue	Spread over DM LIBOR (basis points)
July 1988	29
March 1989	28
September 1989	60
January 1990	71

SOURCE: McCauley and Trickey, op. cit.

[7]Retention of most of the Soviet bond issues by the underwriting banks has an important statistical consequence. When banks report their claims on the Soviet Union through the BIS reporting system, they are supposed to include the value of all bonds they hold. If banks hold Soviet bonds, this debt is captured in the BIS totals, and adding the value of bonds outstanding to the BIS totals would result in double-counting of a part of Soviet debt. Although some of the Soviet bonds are undoubtedly held by nonbanks (which of course do not report to the BIS) the current convention when calculating Soviet debt totals seems to be to assume that the total bank claims reported by the BIS include essentially all of these bonds.

[8]An interest-rate swap is a transaction in which two debtors agree to assume each other's interest payments. Typically, one party will have sold an asset requiring fixed-rate interest payments and the other will be responsible for floating-rate payments. The effect of the swap is that fixed-rate payments are converted to floating-rate payments and vice versa.

Even this probably underestimates the difficulties encountered with the January 1990 issue, the last that the Soviet Union has made. The timing of this issue was very bad. The bond was launched into a DM bond market that was already unsettled by the anticipated heavy government borrowing to finance reunification. Further, the issue was launched in the midst of widespread speculation about the future cohesion of the Soviet Union and about Moscow's ability to control events. Three days earlier, a state of emergency had been declared in Azerbaijan in response to ethnic disturbances and just two days before that President Gorbachev had returned from secessionist-minded Lithuania, where he had been publicly berated by angry crowds. Certainly, these were not circumstances conducive to a successful flotation.

Market perceptions of the flotation were that it was a failure. Even with reported heavy support from the lead underwriter, Westdeutsche Landesbank, early trading in the issue was "below fees"—that is, even after taking their fees underwriters were losing money on sales of the issue.[10] Apparently, both Soviet financial authorities and potential underwriters for future issues also saw the January 1990 issue as a failure. Since then, there have been no further Soviet bond issues.

WHY ISSUE BONDS?

The Soviet motivation for issuing bonds is relatively easy to understand. By 1988, a number of Western banks were approaching the regulatory limits for their exposure to the Soviet Union, and more would do so if the Soviet Union embarked on a major new campaign of foreign borrowing—which, at the time, appeared increasingly likely. For the Soviet Union to increase its net debt further, new lending would have had to come either from banks that had not yet lent much or from nonbanks. Bond issues provided a potential vehicle for tapping nonbank sources of credit. There was also a growing realization in Soviet circles that restructuring the Soviet economy would require both considerable time and large amounts of foreign capital: Short-

[9]McCauley and Trickey, op. cit., p. 51.

[10]Stephen Fidler, "Soviet Union Launches DM500m Issue," *The Financial Times*, January 19, 1990. The fact that the equivalent floating rate on the January 1990 issue was not much worse than that on the September 1989 issues is seen by some observers as evidence of very heavy support by the underwriters of the January bond. The timing of the bond was so bad, they argue, that only heavy support could have presented a significant rise in interest rates.

term credits would not constitute an adequate basis for funding the long-term process of *perestroika*. Additional sources of longer-term finance would be needed, and international bond markets were an obvious place to turn.[11] Also important seems to have been a general desire on the part of many Soviet financial authorities that the Soviet Union should become, as one official put it, a "full member of the international economic community." By this he meant that the Soviet Union would become an active participant in all major international financial markets. Demonstrating access to international bond markets would be a major step in this direction.

The motivations of banks in agreeing to underwrite these bond issues are also fairly easy to understand. Certainly in 1988, and through much of 1989, the Soviet Union was still viewed as a good credit risk, and hopes for *perestroika* were still high. If the opening and restructuring of the Soviet economy were successful, the Soviet Union was likely to emerge as a major customer for a wide variety of financial services in the future. Maintaining a banking relationship with the Soviet Union, then, was a promising business strategy. In the near term, this meant providing credit to the Soviet Union. The hope was that the banks that helped the Soviet Union through the lean years would be its principal bankers when *perestroika* bore fruit. Cautious, though, about their own growing exposure to the Soviet Union, banks were interested in finding credit instruments that could be sold to other investors. Bonds were the obvious answer. The underwriting banks, of course, had no certainty that they would in fact be able to sell the Soviet bonds. Indeed, most of the underwriting banks probably expected to retain a large fraction of the bonds, at least for a few years. But if *perestroika* proceeded successfully, a market for these bonds was likely to develop, and the banks that built an underwriting relationship with the Soviet Union and became recognized as the market makers in Soviet bonds might stand to profit. Even if no significant secondary market ever did develop for Soviet bonds, underwriting banks would simply hold the debt themselves and would be no worse off than if they had simply lent directly. Banks with a long-term interest in a Soviet relationship saw bond underwriting as a no-lose proposition.

[11]The longest maturity available to the Soviet Union through syndicated bank loans was 8 years. Bonds might carry longer maturities—perhaps 15 or 20 years. Only one of the Soviet bonds actually issued (the first) had a maturity longer than could be had in the syndicated loan market. Presumably, though, had the early Soviet bonds been a success, longer maturities would have followed.

SOVIET ACCESS TO OTHER BOND MARKETS

The failure of the January 1990 issue and the general deterioration of the Soviet economic situation have probably closed the international bond market to the Soviet Union for several years to come. As recently as the the fall of 1989, though, Soviet officials were energetically exploring the possibility of bond issues in additional markets. In November 1989, for example, officials of Vneshekonombank made a presentation to institutional investors in London at which they stated clearly VEB's intention to issue bonds in the London market.[12] Soviet financial managers have also evidenced an interest in some rather exotic markets. In early 1989, for example, the first deputy chairman of VEB confirmed that the Soviet Union would study the possibility of raising funds through a Kuwaiti dinar bond issue.[13]

Even if market sentiment should become more favorable, though, the Soviet Union will face obstacles in trying to tap additional bond markets. Bond issues in the United States are currently blocked by the provisions of the Johnson Debt Default Act. The U.S. State Department has confirmed, though, that it has engaged in talks with Soviet officials with the aim of resolving disputed U.S. government loans to pre-Soviet governments.[14] If arrearages on these loans are eliminated, the bar to Soviet bond issues in the New York market will be dissolved. Alternatively, such bond issues would become possible if the Soviet Union becomes a member of the International Monetary Fund. In late 1989—before the political and economic troubles of 1990—the prospects for removing legal bars to a Soviet bond issue in the United States were seen as good enough to support rumors that a Soviet bond issue (to be underwritten by Citibank) was in the works.[15]

Official resistance, if not explicit regulations, hinder Soviet issues in other countries. Unresolved czarist debts seem to be blocking Soviet access to the Paris bond market, and no French institutions have participated in underwriting any of the Soviet bond issues.[16] The Tokyo bond market also seems to be off-limits. The problem here seems to

[12]Freeman, op. cit.

[13]"Soviet Official Says Moscow Will Study Bond Issue in Kuwait," Reuters, February 9, 1989.

[14]"U.S. Confirms Talks Have Begun with Soviets on Czarist Debt," Associated Press, January 17, 1989.

[15]Clyde H. Farnsworth, "Soviets, in a Bid to Borrow, Establish a Bank in the U.S.," *The New York Times*, November 1, 1989.

[16]This is curious in light of the prominence of French banks in lending directly to the Soviet Union (see Figs. 3.3 and 3.4).

be conflicting Soviet and Japanese claims to the Kurile Islands. There is apparently no formal legal barrier to Japanese lending to the Soviet Union, but the Ministry of Finance is widely seen as discouraging high-profile financial dealings with the Soviet Union.[17]

Despite the fact that the Soviet Union did not have access to some major bond markets, the underwriting syndications for Soviet bond issues have been quite cosmopolitan. Among the underwriters for various bond issues have been financial institutions or affiliates of financial institutions headquartered in: Germany, Switzerland, Austria, Japan, Italy, the Netherlands, the United States, the United Kingdom, Belgium, Canada, Finland, and Spain, with as many as eight countries represented in a single syndication. This is in somewhat curious contrast to the trend, beginning in late 1988, toward purely national syndications for Soviet bank loans. The explanation may be that each kind of arrangement—national syndications for bank loans and international syndications for bonds—represented an effort to expand the sources of credit available to the Soviet Union or to improve its terms. National syndications made it easier for Western governments to encourage participation in bank loans whereas international syndicates broadened the range of potential nonbank purchasers (typically not very susceptible to government influence) of Soviet bonds.

SHORTER-TERM ISSUES

In addition to issuing medium-term, fixed-interest hard-currency bonds, the Soviet Union began in 1988 also to issue shorter-term, floating-rate instruments denominated in hard currencies. These kinds of instruments are generally called notes[18] and usually have

[17]Here is a recent example of market commentary on the subject: "With the political disputes over the Kurile Islands . . . continuing, public lending to the USSR is out. The government sees access to capital as a useful lever in negotiations . . . . Hence, [Eastern European] borrowers sneak by into the private placement market. Insurance and leasing companies are willing to buy bonds in structured financings, . . . and banks extend loans in bilateral deals. The omnipresent MoF [Ministry of Finance] knows about these transactions, but old Japan hands say that the officials do not mind so long as they are not done in the public eye. The much-feared demonstrators from the right wing of Japanese society also have a tougher time hearing about them." Excerpted from "Eastern Bloc Targets Tokyo," *International Financial Review*, March 4, 1989, p. 36.

[18]In financial usage, "bond" usually denotes a debt instrument with a fixed interest rate (the coupon rate) and a maturity of greater than a year. "Note" usually signifies a debt instrument with a maturity of a year or less, sometimes with an adjustable interest rate. Also, bonds are typically issued within a specified time period and in

maturities of less than a year. Interest rates are adjusted on a regular schedule and are tied to the prevailing LIBOR. During 1988 and 1989, VEB arranged note-issuing facilities for a maximum of $920 million. (That is to say, VEB arranged with Western financial institutions to issue a maximum of $920 million in short-term notes.) No new facilities have been announced, though, since June 1989. Deteriorating economic and financial circumstances seem to have closed off Soviet access to these markets.

Perhaps surprisingly, the Soviet Union has made little use of its note issuance facilities. At no quarter's end have outstanding Soviet notes ever totaled more than $55 million. (This level was reached in December 1989.) By June 1990, all outstanding Soviet notes had been repaid.[19] Establishing note-issuance facilities appears to have been another attempt on the part of Soviet financial authorities to broaden the Soviet Union's sources of hard-currency credit. It was probably also another reflection of the general desire during the late 1980s to make the Soviet Union a full participant in international financial markets, making use as appropriate of the full range of credit instruments. In a more tactical sense, these note issues seem to have been designed to tap specific pools of international credit that the Soviet Union had not used before. The underwriters and the tender panel of a June 1989 note issuance facility were almost all Singapore banks or Singapore subsidiaries of European banks. Previously, VEB had not been active in the Singapore market.

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specified quantities. Notes, on the other hand, can be issued continuously when and as funds are needed by the borrower, up to some predetermined limit. Rather than issuing all its notes at once, a borrower may set up a "note issuance facility" with a bank or a group of banks through which notes will be issued as necessary.

[19]The Bank for International Settlements has been collecting information on new note-issuing facilities since 1988 and on total notes outstanding since 1987, both by nationality of the borrower. See, *International Banking and Financial Market Developments*, The Bank for International Settlements, Basel. Because of the short maturities of these notes, it is possible that larger amounts were outstanding at times other than quarter ends. There is nothing to suggest heavy use of these facilities at any time, though.

7. OTHER HARD-CURRENCY ASSETS AND LIABILITIES

The bulk of the Soviet hard-currency balance sheet is made up of the kinds of assets and liabilities we have discussed so far: on the liabilities side, bonds and loans from banks and official export credit agencies; on the asset side, bank deposits. These are also the kinds of assets and liabilities about which reasonably reliable data are available. Undoubtedly, though, the Soviet hard-currency balance sheet contains other assets and liabilities. Unfortunately, it is difficult to know their value. Just their existence, though, casts some light on the current international financial circumstances of the Soviet Union, and they are worth discussing, even if only in qualitative terms.

PRIVATE, NONBANK CREDITS

On some occasions, Western firms that export products to the Soviet Union also lend the Soviet Union the funds to pay for these products: Export sales are sometimes made on credit. Unlike banks, Western commercial firms that deal with the Soviet Union are under no obligation to report their outstanding credits, and thus no systematic accounting of these debts is possible. The U.S. Central Intelligence Agency, using methods that are not made public, estimates that at the end of 1989 the value of all Soviet "promissory notes" to Western nonbank entities was about $1.8 billion. The CIA estimates that another $350 million in "nonbank credits" was extended in 1990.

It is only in recent years that Soviet debts to Western nonbanks have become at all significant. In earlier years, most of the financing necessary for Soviet trade transactions came from Western banks and official export credit agencies. In some cases, banks provided this credit by lending directly to the Soviet Union. In others, banks lent indirectly by buying Soviet debt originally extended by exporting firms in the West. Because banks and export credit agencies were willing to provide the necessary credit, there was little need for exporting firms to do so.

The process by which commercial firms sell trade-related debt to banks or other parties is known as forfaiting. Banks that buy these debts are usually free to resell them, and a substantial and well-organized market has grown up in "forfaited" paper. Despite large

volumes of trade-related Soviet debt outstanding, however, no real market for forfaited Soviet paper arose until the late 1980s. This was because Soviet trade paper typically contained clauses—usually called preemption clauses or buyback provisions—giving the Soviet Union right of first refusal in any sale of the paper. Thus, no holder of Soviet trade paper could confidently offer this paper for sale, and no secondary market developed in this paper.

No official explanation was ever offered for the Soviet insistence on the right to buy back their debt. The prevailing view among observers of Soviet financial practice has been that until recently Soviet financial authorities were reluctant to create a situation in which financial markets would regularly and publicly assess the quality of Soviet debt. According to this view, these authorities did not want to confront daily indices of financial market confidence in the Soviet Union in the form of quotes on forfaited Soviet trade paper. Before the Soviet Union began issuing bonds in January 1988, Soviet trade paper was the only kind of Soviet liability for which an organized secondary market might conceivably have developed. By adding buyback provision to these debts, the Soviet Union could prevent any secondary market in Soviet obligations from developing.

For their part, banks and nonbank lenders agreed to these conditions. Most entities that extended credit to the Soviet Union in those years were willing to hold the resulting debt, so resale restrictions were largely irrelevant. By the late 1980s, though, buyback provisions had largely disappeared from Soviet trade paper. In part, this was because banks were becoming reluctant to create or to buy trade paper that contained such provisions. Less sure of the quality of Soviet debt, they were increasingly interested in having a liquid secondary market that would allow them to adjust their levels of Soviet exposure as they thought appropriate. Also, the flotation of Soviet bonds created the potential for a secondary market in Soviet liabilities,[1] and there was no longer much point for the Soviet Union in trying to discourage secondary trading in its trade paper. Finally, in the late 1980s, there seems to have been a real change in Soviet official attitudes toward international financial markets. After years of distrusting and generally avoiding these markets, Soviet financial authorities began to seek full and normal participation in these markets on the same terms on which other countries participated.

[1]Indeed, both Soviet financial authorities and the Western banks that underwrote these bond issues hoped such markets would develop.

Recent years have also seen attempts by the Soviet Union to arrange some distinctly nontraditional sorts of borrowing from nonbanks in the West. Perhaps the most curious of these efforts was an agreement concluded in July 1990 between De Beers Centenary, a Swiss subsidiary of the De Beers South African mining group, and Glavalmazzoloto, the Soviet precious metals and diamond trading organization. Under the terms of this agreement, De Beers advanced a $1 billion loan to the Soviet diamond industry. Diamonds worth a similar amount were to be shipped from the Moscow State Treasury to De Beers' Central Selling Organization in London to be held as collateral for the loan.[2] The deal became more curious a week later when it was announced in Moscow that senior diamond marketing officials had been reprimanded for "failure of discipline and crude violations in the conduct of commercial operations involving the sale of state-owned precious stones for hard currency on foreign markets." The accusations were apparently not directly related to the De Beers loan, but they put the entire transaction under a cloud.[3] On August 9, the Presidium of the RSFSR Supreme Soviet adopted a decree invalidating foreign economic agreements involving the sale of certain strategic resources and products extracted or manufactured on Russian territory if these agreements were not approved by the Russian Federation. The decree mentioned specifically diamonds, precious and other metals, oil, gas, and uranium,[4] and was seen as a direct challenge to Soviet officials, who had negotiated the De Beers agreement. A few days later, though, the First Vice President of the Russian Federation said that despite the decree, his republic was in fact prepared to implement the De Beers deal.[5] The final twist in this story came shortly thereafter, when the government of the Yakutsk region asserted (apparently ineffectually) that it, not the government of the Russian Federation, had the right to approve or disapprove sales of diamonds produced in its territory. Little wonder that foreign creditors and investors are sometimes at a loss to know with whom in the Soviet Union they should be dealing.

[2]Kenneth Gooding, "Moscow in $5 Billion Diamond Agreement with De Beers" and "Soviet Union Takes 'Rightful Place' in Diamond Cartel," both in *The Financial Times*. July 26, 1990.

[3]Leyla Boulton and Anthony Robinson, "Moscow Rebukes Officials over Diamond Sales," *The Financial Times*, August 2, 1990.

[4]Lev Aksenov, "RSFSR Asserts Sovereignty over Export of Strategic Resources," *Tass in English*, August 9, 1990.

[5]Ron Popeski, "Diamond Deal To Be Respected, Says Top Russian," Reuters, August 20, 1990.

In another indication that nontraditional (at least as far as the Soviet Union is concerned) borrowing arrangements are being contemplated, Viktor Gerashchenko, the head of Gosbank, has claimed to have reached understandings with the central banks of "neutral countries" which would allow the Soviet Union to raise hard-currency funds through gold swaps.[6] In a swap transaction, gold reserves are offered in exchange ("swapped") for hard currency with the understanding that the transaction will be reversed at some specified future date. In essence, the gold serves as collateral for a hard-currency loan. Swap transactions are not uncommon among Western countries, but this technique had never been used by the Soviet Union. The existence of these swap lines has not been confirmed by any Western central banks, and there is no indication that the Soviet Union has actually drawn on any of these lines.[7]

IMPORT PAYMENT ARREARAGES

Beginning in the fall of 1989, another class of hard-currency claims on the Soviet Union became significant in the overall Soviet balance sheet. These were claims by Western exporters who had not received negotiated payments from Soviet importers for goods already delivered. The lending implicit in these payment arrearages was involuntary on the part of Western exporters. None had an intention of extending credit to the Soviet Union; all expected payment in accordance with their trade contracts. Nonetheless, these arrearages do reflect obligations of Soviet entities to make hard-currency payments and should, therefore, be counted among the Soviet Union's hard-currency liabilities.

It is impossible to develop any reliable estimate of the extent of these payment arrearages. In none of the major Western economies are exporters required to report payment delays from foreign customers. Information on arrearages appears sporadically—usually from individual firms or from groups of exporters (e.g., grain exporters from a particular country)—but this information is highly anecdotal and its accuracy is impossible to check.

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[6]Stephen Fidler, "Moscow to End Delays in Payments to Creditors This Year," *The Financial Times*, June 11, 1990.

[7]However, there has been at least one report that the Soviet Union has offered gold as collateral for loans from private Western banks. See "Russian Minister Denounces Soviet Union's Sale of Gold," Reuters, August 20, 1990.

Soviet financial officials acknowledge that payments for imports are substantially in arrears, but to date no official Soviet estimate of the extent of these arrearages has been offered. Indeed, it is unlikely that Soviet officials could compile such an estimate. By most accounts, these payment arrearages have arisen because enterprises, ministries, and foreign trade organizations have been exercising their new rights to enter into trade contracts without approval from central authorities. Without knowledge of all the deals entered into, central authorities presumably have no way of knowing what payments are due when and hence no way of knowing the full extent of arrearages. For these reasons, all estimates of import payment arrearages are necessarily speculative. Nonetheless, all sources seem to agree that they are substantial. Estimates for the end of 1990 ranged from $4 to $6 billion.[8] The circumstances that gave rise to these arrearages are discussed in more detail in Sec. 8.

SOVIET HARD-CURRENCY CLAIMS ON DEVELOPING COUNTRIES

Missing from most accountings of the Soviet hard-currency balance sheet are Soviet hard-currency claims on developing countries. For the most part, these claims have arisen from Soviet aid—often military aid—programs in developing countries. The Soviet Union has provided aid—typically in the form of goods and services rather than in cash—and recipient countries have agreed to pay for this aid in hard currencies at some future date. Western analysts have long known of the existence of such agreements, but no systematic accounting has been possible.

In February 1990, though, V. G. Panskov, the Soviet Deputy Minister of Finance, told the Congress of People's Deputies that Soviet claims on foreign countries amounted to R85.8 billion as of November 1, 1989.[9] In reporting Panskov's comments, *Izvestiya* also provided a detailed listing of these foreign claims. A little more than half of the total (R43.8 billion) was accounted for by claims on what *Izvestiya* called "socialist countries."[10] Most of these were presumably not hard-currency claims. The rest of the claims (R42.0 billion, or $67.3 billion at the official exchange rate), though, were on "developing countries" and may have been payable in hard currencies (see Table 7.1). The largest claims were on India, Syria, Iraq, Afghanistan,

[8]In its 1991 Annual Report, the Bank for International Settlements estimates these arrearages at $5 billion (p. 85).

[9]*Izvestiya*, March 2, 1990.

[10]Included in this category were CMEA members plus Albania, North Korea, China, Laos, and Yugoslavia.

Ethiopia, Algeria, and Angola. Together, these seven countries owed the Soviet Union some R29 billion.

There seems little reason to view these Soviet claims as real assets. Western financial markets have deeply discounted the value of much developing country debt to Western banks. The debt of some countries is being traded for only a few cents on the dollar of face value. Soviet claims on developing countries are probably worth even less. The Soviet Union has lent heavily to some countries (Afghanistan, Angola, and Ethiopia stand out) that were not considered good enough credit risks for Western banks to lend to. Other countries may have weaker incentives to service or to repay their debts to the Soviet Union than their debts to Western banks. The only real reason

Table 7.1

Soviet Claims on Developing Countries, November 1, 1989 (in millions of rubles)

Country	Claim	Country	Claim
Afghanistan	3,055.0	Libya	1,707.3
Algeria	2,519.3	Madagascar	100.6
Angola	2,028.9	Mali	285.0
Bangladesh	6.6	Morocco	2.2
Benin	31.6	Mozambique	808.6
Burkino Faso	4.3	Nepal	2.0
Burundi	14.8	Nicaragua	917.3
Cambodia	714.8	Nigeria	26.7
Cameroon	0.6	Pakistan	173.8
Cape Verde	7.2	Peru	541.1
Central African Republic	1.0	Sao Tome and Principe	4.8
Chad	2.2	Senegal	1.6
Congo	199.5	Seychelles	0.2
Egypt	1,711.3	Somalia	260.8
Equatorial Guinea	1.5	South Yemen	1,847.6
Ethiopia	2,860.5	Sri Lanka	1.1
Ghana	9.6	Sudan	3.8
Grenada	0.2	Syria	6,742.6
Guinea	258.3	Tanzania	310.3
Guinea-Bisau	66.0	Tunisia	17.7
India	8,907.5	Turkey	91.8
Indonesia	404.5	Uganda	36.4
Iran	1.0	Yemen	979.6
Iraq	3,795.6	Zambia	206.0
Jordan	369.0		
		Total	42,039.7

SOURCE: *Izvestiya*, March 2, 1990.

to service or to repay a debt is to preserve access to borrowing in the future. Western banks are more and more reluctant to lend to many developing countries, but some future lending is possible to countries that have kept current in their debt service. The increasingly difficult economic and financial circumstances of the Soviet Union, though, make significant further lending to developing countries very unlikely. If there is any additional Soviet lending, it will likely be for political reasons and not strongly influenced by the prospects for repayment. Why, then, should a debtor country repay the Soviet Union? The true value of Soviet claims on developing countries is probably close to zero, and it is therefore probably reasonable to ignore these claims in drawing up the overall Soviet hard-currency balance sheet.

8. SOME QUESTIONS ABOUT SOVIET INTERNATIONAL FINANCE

Preceding sections have outlined the general shape of the Soviet hard-currency balance sheet and noted some recent developments in Soviet international finance. In this section, we turn to a number of questions about the character of Soviet international financial relations and how they have developed in recent years.

WHAT CAUSED THE 1989 BORROWING BINGE?

The first, and in some ways the most important, question arises from a consideration of the time pattern of net Soviet borrowing (see Fig. 3.1). During the first three and a half years of the Gorbachev era, Soviet foreign borrowing was extremely restrained. After adjusting for exchange rate changes, net Soviet borrowing from mid-1985 to the end of 1988 amounted to only about $800 million. In 1989, though, the Soviet Union embarked on what can only be called a borrowing binge. Even without considering the debts implicit in delayed payments for imports, Soviet borrowing during 1989 was $9.1 billion—more than ten times the borrowing of the preceding three and a half years. The first quarter of 1990 saw an additional $3 billion in net borrowing from Western banks alone, and we now know that during this period Soviet importers were falling rapidly behind in their foreign payments. The borrowing binge came to an abrupt end in the second quarter of 1990, when Western banks refused to roll over a large amount of maturing Soviet debt, effectively cutting off hard-currency credit to the Soviet Union on normal commercial terms. The question posed by this history is: After three and a half years of restraint, why did the Soviet Union suddenly embark on such an extravagant program of foreign borrowing?

The answer would appear to be largely political. The early years of the Gorbachev era were marked by a vigorous and very public debate within Soviet policy circles about the role that foreign borrowing should play in the process of *perestroika*. Most Soviet authorities seemed to recognize that the Soviet economy could not grow without a significant inflow of foreign capital. There was deep disagreement, though, over when in the process of reform this inflow would be appropriate.

A group of more radical economists (the most prominent of whom was probably Nikolai Shmelev) argued that heavy borrowing from the West in the early stages of *perestroika* would serve to "jump start" the process of economic reform in the Soviet Union. Borrowing would finance imports of capital equipment necessary to modernize Soviet industry. Imports of consumer goods would help to meet pressing current needs, buying time for the productivity gains that would result from modernized industry to be felt. Central authorities also hoped to trade increased availability of consumer goods for higher levels of labor productivity. Improved labor discipline was to be rewarded by higher wages, which would be of value only if they could be used to purchase consumer goods. Finally, increased imports of consumer goods were seen by some as a tool of monetary policy. By marking up the ruble price of imported goods, the Soviet government could also increase its revenues and begin to reduce the large ruble balances held in personal savings accounts.[1] (Allegedly, these large balances had been built up because there were few consumer goods to spend rubles on.) Eliminating this "ruble overhang" was seen as a key prerequisite to decontrol of consumer prices. Unless the ruble money supply were reduced, it was feared, market-determined prices would be bid up sharply. A round of rapid price inflation would bring redistributions of income and wealth that Soviet society might find difficult to deal with.

Opposition to an early recourse to foreign borrowing sprang, naturally, from concerns over the subsequent burden of servicing a large increase in debt. Some critics of heavy foreign borrowing (including, prominently, the Soviet Premier, Nikolai Ryzhkov) pointed out, quite reasonably, the dangers of borrowing to finance imports of consumer goods. Additional consumer goods, they argued, would do nothing to increase the ability of the Soviet Union to produce exportable goods and would therefore contribute nothing to subsequent ability to service additional debt. A more sophisticated argument against using foreign borrowing to "jump start" the Soviet economy held that even borrowing to finance capital goods imports could be dangerous. In the existing distorted Soviet economy, critics said, there was little hope that imported capital equipment would be put to productive use. For these critics (including some officials of Gosbank), fundamental reform of the Soviet economy—price reform, new concepts of property ownership and entrepreneurial freedom, etc.—had to precede a large inflow of foreign capital. To borrow heavily in advance of economic

[1]The most provocative statements of this idea were by Shmelev. See *Znamya*, January 1989 (translation in JPRS-UEA-89-014, June 1, 1989, pp. 5–19).

reform would be simply to incur debt-servicing obligations without creating the productive capacity to generate the hard currency necessary to meet these obligations.

While the debate lasted, the operative policy was one of caution; there was little foreign borrowing. In the end, though, the debate was overtaken by political events. Growing dissatisfaction (which could be voiced more and more publicly, thanks to *glasnost*) with the failure of the civilian goods sector of the Soviet economy led in early 1989 to a change in official economic policy. Factories in the heavy industry sector were to be converted to consumer goods production, and investment in light industry was to be tripled.[2] In announcing the new policy, the government specifically ruled out a crash program to import consumer goods. The heavy emphasis, though, on investment in light industry signaled sharply increased needs for machinery imports. In retrospect, it appears that the new policy must have been decided upon some months earlier and that the large nationally syndicated loans negotiated in the last quarter of 1988 were to provide much of the financing for these additional imports. The Italian and German credits as well as the never-completed British and French deals were specifically intended to support imports of machinery and equipment for Soviet light industry.

Increased investment in light industry did not, of course, bring any immediate increase in the supply of consumer goods, and shortages continued to worsen. In March 1989, a small group of Siberian coal miners gained international attention by striking, partially to protest inadequate supplies of consumer goods.[3] Apparently fearing that such strikes would spread, the Soviet government did in fact embark on a crash import program, announcing that an additional R5 billion had been allocated for consumer imports. This was not enough, however, and by the summer of 1989, strikes among Siberian miners had become widespread. As part of the settlement to get the miners back to work, Soviet authorities agreed to increase deliveries of food and other consumer goods to the mining towns. Deputy prime minister Aleksandra Biryukova was dispatched to the United Kingdom on a much publicized "shopping trip," and in September the deputy foreign trade minister confirmed that the Soviet Union had even further

[2]Quentin Peel, "Moscow Moves on Shortages," *The Financial Times*, January 14, 1989.

[3]Quentin Peel, "Small Strike Shows Up Large Soviet Failures," *The Financial Times*, March 14, 1989.

[4]John Lloyd, "Moscow To Buy More Consumer Goods from West," *The Financial Times*, April 15, 1989.

increased its imports of food and consumer goods.[5] The need to rebuild after the disastrous Armenian earthquake, which occurred in late 1988, also added to import spending early in 1989.

This import surge is clearly visible in Soviet merchandise trade figures. In 1988, the Soviet Union recorded a hard-currency merchandise trade surplus of $4.8 billion. By 1989, this surplus had evaporated, as the value of merchandise imports grew by $6.7 billion or 23 percent.[6]

WHAT DOES THE SOVIET UNION DO WITH BORROWED FUNDS?

This may at first seem a peculiar question. Soviet import needs have grown rapidly in recent years, and the Soviet Union has had to borrow hard currencies to maintain and to expand imports of food, consumer goods, and capital equipment. The puzzle here lies in the fact that it was only in 1989 that total Soviet import spending for goods and services exceeded Soviet export earnings (including earnings from gold sales). Yet, throughout most of the 1980s, the Soviet Union was a net borrower from the West. Even in 1989, the Soviet hard-currency current account, including revenue from gold sales, was in deficit by only about $200 million. We know, though, that net Soviet borrowing from the West during 1989 was about $10 billion (including payment arrearages). What was the Soviet Union doing with all the funds it borrowed?

An earlier RAND report noted this discrepancy and suggested that a large part of the discrepancy might be explained by the fact that some hard-currency transactions were missing from the observed Soviet hard-currency balance of payments.[7] Specifically, that report suggested that significant amounts of hard currency (a few billion dollars per year) were being passed on by the Soviet Union to developing countries in the form of hard-currency loans (which might or might not ever be repaid) or as exports for which the Soviet Union had not received (and might never receive) payment. In the past, the Soviet Union might, in essence, have been using its very good standing in

[5] "Soviet Union Carrying Out Massive Import Programme," Reuters, September 3, 1989.

[6] Imports had also risen by 24 percent in 1988, but this increase was easily covered by the substantial hard-currency current account surplus the Soviet Union then enjoyed.

[7] Neu and Lund, op. cit., pp. 34–41.

international credit markets to borrow funds on behalf of client states on terms that were more attractive than these client states could have gotten on their own. There are now additional suggestions that this has been the case. As we noted in Sec. 7, the Soviet Union recently acknowledged outstanding credits to nonsocialist developing countries with a combined face value of R42 billion ($67 billion). Since publication of the earlier RAND report, the CIA has has also begun to publish rough estimates of net Soviet hard-currency credits to developing countries.[8]

These estimates and the discrepancies between apparent Soviet credit needs and actual Soviet borrowing are summarized in Table 8.1. The first row of the table shows joint IMF, World Bank, OECD, and European Bank for Reconstruction and Development (EBRD) estimates of the Soviet hard-currency current account balance. (1984 figures are from the CIA.) The second row shows estimates from the same sources of Soviet revenues from gold sales. The third row, the sum of

Table 8.1

Soviet Credit Needs and Net Borrowing, 1984–1989 (in billions of U.S. dollars)

	1984	1985	1986	1987	1988	1989	1990
(1) Soviet hard-currency current account	4.7	-0.5	1.8	6.6	1.6	-3.9	-10.7
(2) Revenues from gold sales	1.0	1.8	4.0	3.5	3.8	3.7	3.6
(3) Apparent net credit requirement (minus)	5.7	1.3	5.8	10.1	5.4	-0.2	-7.1
(4) Observed net borrowing[a]	-0.5	1.2	1.3	-0.5	2.3	9.1	0.2
(5) "Excess" borrowing[a]	5.2	2.5	7.1	9.6	7.7	8.9	6.9
(6) Net credits to developing countries (CIA estimates)	2.7	1.7	4.1	4.8	5.5	5.7	N.A.

SOURCES: BIS, OECD, World Bank, IMF, and CIA.
[a]Excluding payment arrearages.

[8]*Handbook of Economic Statistics*, September 1990, p. 75.

the first two, is the negative of apparent Soviet net borrowing needs.[9] Figures in the fourth row are derived from Fig. 3.1 and represent observed Soviet net borrowing in Western credit markets, excluding payment arrearages. Notice that in each year up to 1989, the amount borrowed exceeds the apparent requirement. The fifth row shows the amount of "excess" borrowing in each year, and the last row shows CIA estimates of how much of this "excess" was passed on to developing countries in the form of hard-currency credits.[10]

What is striking about Table 8.1 is that both the amount of apparently "excess" borrowing and the amount being passed on by the Soviet Union to developing countries increased in the late 1980s. The increasingly difficult economic circumstances of the Soviet Union had not had a visible effect on Soviet aid—in hard currency or in kind—for developing countries aligned with the Soviet Union.[11] The situation was quite different in 1990. In that year, net Soviet borrowing does not appear to have been large enough to finance the gap between apparent Soviet hard-currency spending and hard-currency receipts. (Of course, foreign credits had to be adequate to cover the shortfall. Otherwise, there could have been no shortfall. Involuntary lending resulting from Soviet payment arrearages—not included in Table 8.1—probably accounts for much of the discrepancy.) We do not yet have CIA estimates for the flow of Soviet credit to the Third World in 1990, but these credits were almost certainly sharply curtailed.

[9]In 1989, for example, the Soviet hard-currency current account was in deficit by about $3.9 billion. Gold sales financed about $3.7 billion of this deficit, leaving a net borrowing requirement of somewhat less than $200 million.

[10]If we accept the CIA estimates of Soviet aid to developing countries, there is still a substantial amount of "excess" Soviet borrowing that is unaccounted for. Included in this amount may be hard-currency transactions with CMEA countries, Soviet trade credits to facilitate the sale of Soviet exports to industrialized countries, and simple errors in other parts of the current and capital accounts. Further research is needed, though, to establish conclusively what the Soviet Union has been doing with its borrowed funds.

[11]To the extent that these estimates of Soviet aid to other countries reflect aid in kind—exports that are not paid for—they may be somewhat exaggerated. These unseen flows to other countries are essentially balancing items, necessary to offset reported Soviet merchandise exports. If the value of the exports in question is inflated, the necessary balancing item will also be inflated. If these exports are commodity-like (e.g., oil or natural gas), reported values may be realistic. If the exports are manufactured products not sold elsewhere in world markets (arms come particularly to mind), values might be considerably exaggerated. In this case, estimates of Soviet aid to Third-World countries and estimates of "excess" Soviet borrowing may somewhat overstate the scope for potential belt-tightening in Soviet aid programs.

WHY HAVE SOVIET INTERNATIONAL PAYMENTS FALLEN INTO ARREARS?

Early in March 1990, the Western financial press began to carry stories about delays in payments due to Western firms from state-owned Soviet trading companies.[12] As news of these payment delays accumulated, it became clear that they had first appeared in November 1989. By the spring of 1990, they were subjects of ministerial-level consultations between the Soviet and Western governments.[13] Despite special efforts by Soviet authorities to clear up these delays[14] and new loans specifically intended to reduce payment delays, the arrearages persist.

Before the end of 1989, the Soviet Union had compiled a nearly spotless record in meeting its international financial obligations. What payment delays had occurred in the past had been only a few days in duration and due entirely to technical or bureaucratic errors. Months-long payment delays were a new phenomenon, and both Western business interests and Western observers of the Soviet Union were puzzled about their causes. The most puzzling aspect of these delays was that they arose at a time when the Soviet Union—or, more specifically, VEB—had large reserves of hard currency at its disposal. At the end of 1989, for example, VEB had deposits in Western banks worth some $14.7 billion. The Soviet financial position might well have been deteriorating, but certainly the Soviet Union faced no immediate liquidity crisis. Supporting this view is the fact that VEB itself maintained and has continued to maintain an unblemished payment record. All delays have been in payments owed to Western interests by foreign trade organizations.

To many observers, this is the key to explaining the payment delays. The trade reforms of the late 1980s eliminated the foreign trade monopoly of the Ministry of Foreign Trade and allowed other

[12]Among the earliest of these reports were: "Western Business Reports Payment Delays on Soviet Trade," Reuters, March 2, 1990; and Laurie Haye and Peter Gumbel, "Soviet Companies Lag in Making Payments to Western Suppliers," *Wall Street Journal*, March 7, 1990.

[13]For example, in March, both British Trade and Industry Secretary Nicholas Ridley and French Finance Minister Pierre Beregovoy publicly acknowledged that they had discussed the issue during visits to Moscow. See Peter Montagnon, "Ridley Unruffled by Late Soviet Payments," *The Financial Times*, March 22, 1990; and William Dawkins, "France Agrees Soviet Trade Debts Delay," *The Financial Times*, March 29, 1990.

[14]See Quentin Peel, "Moscow Acts on Backlog of Payments to West," *The Financial Times*, May 23, 1990; and Peter Montagnon, "Moscow Scrambles to Redeem Credit Rating," *The Financial Times*, May 25, 1990.

ministries and enterprises to enter directly into trade transactions with Western firms. Like most international trade transactions, these typically involved the immediate delivery of Western goods to Soviet purchasers, with payment due a few months later. As a result of financial inexperience or overzealous import activity, some of these new trading entities apparently found themselves overextended and unable to marshal the hard-currency funds necessary to meet their payment obligations. This, in itself, should not necessarily have created a serious problem. Importing firms in all countries from time to time find themselves short of the resources necessary to make required payments. The usual practice in these instances is to borrow the funds necessary to meet current obligations. In the absence of functioning markets for hard-currency funds, though, Soviet importers caught short had nowhere to turn but to VEB.

In some cases, VEB refused assistance. In some of these cases, trading entities had simply committed more hard-currency funds than they could claim from VEB, relying perhaps on the traditional willingness of Soviet central authorities to bail out imprudently managed enterprises. VEB's refusal to assist was generally consistent with the prevailing trend in Soviet economic policy of holding enterprises and trade organizations increasingly responsible for the consequences of their own actions. There were suggestions also, though, that VEB officials saw the bank's traditional central role in Soviet international finance as threatened. A demonstration, it was suggested, that agreements made with entities other than VEB could not always be relied upon might encourage Western firms to concentrate their dealings with VEB. Indeed, there were even reports that VEB was denying enterprises and foreign trade organizations access to "retention accounts" (accounts with VEB in which trading entities had deposited hard currencies and to which, at least in theory, they had unconditional access).[15] Suspicions that VEB was (and perhaps still is) protecting its own bureaucratic interests at the expense of some trading organizations and their Western creditors are not confined to Western observers. Soviet officials outside VEB voice similar suspicions in private conversations.

If VEB was acting in this manner, it achieved its aim—in at least one respect. By the summer of 1990, the financial press was carrying numerous reports of Western exporters refusing to do business with the Soviet Union without irrevocable letters of credit, either from VEB or from Western banks. Western banks, in turn, would issue

[15] *Business Eastern Europe*, March 9, 1990, p. 5.

such letters only with guarantees from VEB. VEB was effectively back in the driver's seat.

But the longer-run consequences of these payment arrearages are likely to be—in fact, they already are—damaging to VEB's ability to raise funds in international credit markets. As we noted above, Western banks have already sharply reduced their overall Soviet exposure. Delays that first arose as a consequence of bad business decisions and bureaucratic maneuvering may end up reflecting—indeed, contributing to—true liquidity problems. Even this, though, may not be entirely unwelcome in some Soviet quarters. There certainly have been elements of the Soviet establishment opposed to decentralization of foreign trade, growing reliance on imports, or the increased borrowing necessary to finance these imports. A reduced ability to borrow and thus to import may be consistent with these interests.

HOW GOOD IS SOVIET INTERNATIONAL FINANCIAL MANAGEMENT?

Until recently, little has been known in the West about what we might call the "style" of Soviet international finance. More specifically, it was hard to judge how good or how sophisticated Soviet financial managers are in conducting their affairs. We saw much (but certainly not all) of what the Soviet Union *did* in international financial dealings. But we understood little of *why*: why particular transactions took place, why deals were structured as they were, why certain kinds of deals never seemed to happen, etc. Neither did we understand much about *who* within the Soviet Union was managing international financial strategy. In particular, it was hard to form much of a view about how well Soviet international finance was being managed.

Partly, this was because of Soviet reticence to discuss financial matters and the refusal or failure of the Soviet Union to publish even the most basic statistics on international financial activities. Perhaps more important, though, our understanding was limited by the fact that the Soviet Union restricted its international financial dealings to a fairly narrow set of transactions. There was borrowing from banks and official export credit agencies, deposit placement in banks, foreign exchange and precious metals trading, but little else. It was hard to judge the style or the sophistication of Soviet financial management because we did not have many specific examples of such

management. All we knew for sure was that there was a clear Soviet preference for sticking to the basics of international finance.

In this factual vacuum, a lot of (mostly unsubstantiated) opinions circulated regarding the "true" level of Soviet financial sophistication. Some indications supported a view of considerable competence and sophistication in Soviet financial management. One heard, for example, that Soviet loan negotiators were very tough and shrewd bargainers. The few Soviet financial officials who held positions in Soviet-controlled Western banks were usually well regarded by other bankers. Some younger Soviet financial specialists were posted for a year or so to banks in the West to learn Western financial practice.[16] Less plausibly, there were rumors in the financial community that Soviet traders (Soviet foreign exchange traders and grain traders were the usual subjects of such stories) were exploiting information gathered by Soviet intelligence services to steal a march on their capitalist counterparts.[17]

There were also indications that, in some regards at least, Soviet financial management was quite unsophisticated—some went so far as to say incompetent. The messy and public failure of Soviet-controlled Wozchod Handelsbank in Zurich in 1984 pointed to apparent gaps in the ability of Soviet authorities to monitor the foreign exchange and precious metals dealings of some of its agents. More routinely, the apparent lack of interest on the part of Soviet officials in holding any hard-currency assets other than relatively low-yielding short-term bank deposits was seen by some observers as an indication that these officials did not understand the potential benefits of a more diverse portfolio.

Our understanding of the style and sophistication of Soviet international finance has improved somewhat in recent years. There is much we still do not know—most important, precisely who is

[16]*Izvestiya* recently provided a (possibly exaggerated) example of how highly Western firms regard some young Soviet financiers. In an article titled "The Brain of the Soviet Banker Is Expensive in the World Market," the newspaper reported that a 30-year-old former currency dealer with VEB had been hired by the New York investment banking firm, Solomon Brothers, for an annual salary of "about $200,000." See JPRS-UEA-91-009, February 26, 1991, pp. 4–5.

[17]This idea never seemed very credible. It is, of course, possible that Soviet intelligence services penetrated Western central banks or finance ministries. The value of such penetration, if in fact it occurred, must lie, however, in the long-term insights it might allow into the policies and opportunities of Western governments. It is hard to believe that Soviet intelligence officials would allow their sources to be compromised—as they might well be if Soviet financial managers traded regularly on information from these sources—simply to make a quick killing in foreign currency markets.

responsible for formulating Soviet international financial policy. (But who, for that matter, is formulating any aspect of Soviet economic policy?) We have, though, made some progress. There is now a greater willingness on the part of Soviet officials to discuss international financial matters. And although there are still few official statistics, some additional information on international financial dealings is slowly appearing. Perhaps most important, as Soviet international financial dealings have become more diversified we have had more opportunities to observe Soviet financial management.

What we have seen in recent years suggests that at least at a general, strategic level Soviet financial management is becoming more sophisticated. The decision to enter international bond markets, for example, reflects a recognition of the need to lengthen the maturity of Soviet debt, to tap new credit sources, and to make the Soviet Union less vulnerable to sudden shifts in market sentiment. In both public and private, Soviet officials have stressed that making the Soviet Union a full player in international financial affairs is a key part of the larger restructuring of the Soviet economy that must take place. Finally, the willingness to allow Soviet debt—bonds and trade-related paper—to be traded in secondary markets shows a clear evolution in the politics of Soviet international finance. If a country is to be a full participant in international markets it must submit to market assessments. That this is now apparently understood—or at least accepted—in the Soviet Union is an indication of an increasingly sophisticated appreciation of how international markets work and how they can be used.

Somewhat in contrast with this increased sophistication at the strategic level, the past couple of years have seen some examples of apparently inept behavior at the operational level. The fact that payment delays have been allowed to persist, even after Soviet officials have assured Western firms and governments that steps are being taken to eliminate arrearages, shows some inability (whether technical, bureaucratic, or political, it is hard to say) to get things done at the operational level.

There are also indications that Soviet financial managers do not yet have the flexibility or the freedom of action necessary to take advantage of financial market opportunities and to avoid market pitfalls. The clearest example of a failure to avoid a pitfall is the last Soviet international bond issue—the DM500 million issue floated in Frankfurt in January 1990. As we noted in Sec. 6, this issue was seen as an embarrassment both for the underwriting banks and for the Soviet Union.

In hindsight, it is not surprising that the issue was not successful. More to the point, though, even relatively unsophisticated observers of international bond markets—to say nothing of the very experienced underwriting teams at major German banks—should have seen trouble coming and canceled or postponed the issue. Why, then, had the issue gone ahead?

From the point of view of the underwriters, the issue seems to have gone ahead because the Soviets wanted it to. Although the underwriters may have had doubts about the issue, their concern for their future relations with the Soviet Union seems to have kept them from backing out of the issue. Some small losses on a particular bond issue may have appeared less important than the potential loss of a leading position in handling Soviet international financial affairs. (I did, however, hear some bankers suggest that if *their* banks had been managing the issue, it never would have happened. Perhaps.)

But why would VEB officials not have stopped the issue? I raised precisely this issue in private conversations with Soviet officials. They admitted that the issue had not gone well. They noted also that Soviet financial specialists had foreseen this. The problem, apparently, was that these specialists did not have the authority to postpone or to cancel the issue. A major bond issue, I was told, was then (and presumably would be today, if another were contemplated) an event with sufficient political import that approval was required "from the highest levels" before one could go ahead. Political approval is given by politicians, not by financial specialists. Having once received approval for a bond issue, the financial specialists were apparently reluctant to go back to their political masters for a decision to postpone or cancel when the market turned sour. Without advice from the specialists, politicians neither recognized that market conditions were deteriorating nor understood the implications of this. Thus, the issue went ahead.

Beyond the political constraints that Soviet financial managers seem to labor under, there also seems to be a serious shortage both in Soviet governmental offices and in enterprises and foreign trade organizations of staff with even basic technical knowledge of financial markets. In discussing the reasons for the very conservative approach that Soviet managers have taken in holding sizable hard-currency reserves, Soviet officials point out the political obstacles: There is still something a little suspect about "speculating" in financial market assets like foreign-currency bonds. Similarly, they point out the bureaucratic obstacles: Higher-yielding assets may involve

more risk, and the penalties that a technician in Gosbank or VEB might face for losing money in an adverse market swing are much greater than the (quite possibly nonexistent) penalties he might face for failing to earn a higher yield in the first place. The Soviet failure to manage its hard-currency reserves more actively or aggressively apparently also stems from a shortage of staff competent to manage a more complex or diversified portfolio. A senior official at Gosbank told me, for example, that it was not until 1985 that Gosbank had someone on its staff who could correctly calculate bond yields. When I expressed amazement at this statement, the official went on to explain that the problem did not end even there. The new staff member with a knowledge of bond yield calculations was a young man, to whom some of the more senior managers in the seniority-conscious bank paid little attention.

WHITHER THE RUBLE?

This report has focused almost exclusively on flows of hard-currency funds that result from Western lending to the Soviet Union and Soviet lending (principally in the form of bank deposits) to the West. The other primary vehicle for international capital flows, direct foreign investment, has been ignored—partly because no good statistics on direct investment flows into or out of the Soviet Union are available, but principally because such flows have been quite small to date.

There are many reasons why foreigners have shied away from direct investment in the Soviet Union. The absence of a clear Soviet concept of property ownership, the absence of a legal system for settling business disputes, the undependable supply of locally sourced inputs, and the complex of changing and inconsistent union, republican, and municipal regulations affecting every aspect of business activity are among the most often cited deterrents of foreign investment. Also important, though, and more directly related to Soviet international financial policy has been the difficulty of getting hard-currency profits out of the Soviet Union.

At the center of this difficulty lies the nonconvertibility of the ruble. A commercially successful operation in the Soviet Union may generate large ruble profits. Without some mechanism, though, for converting rubles into hard currency and repatriating these profits, a foreign investor has no straightforward way to realize a hard-currency rate of return on his original hard-currency investment. To

date, most Western investments in the Soviet Union have generated hard-currency earnings only through complicated arrangements involving barter or the export from the Soviet Union of goods or services that can be sold for hard currency.

The nonconvertibility of the ruble also complicates and distorts Soviet trade transactions. Because rubles cannot be easily converted into hard currencies, would-be Soviet importers have first to acquire hard currency before they can complete a trade transaction. Simply having plenty of rubles does not guarantee access to hard currency. Rather, importers must either convince Soviet financial authorities to allocate scarce hard currency to the proposed transaction, even the necessary hard currency through exports, or borrow from abroad. Excessive zeal in doing the last of these seems to explain, at least partially, the payment arrearages that arose in late 1989 and 1990.

Just as problematic, an exporter has no way of selling excess hard currency to other Soviet entities or enterprises that might wish to obtain foreign currency. Regulations promulgated in November 1990 require that a significant fraction of all hard-currency export revenues be turned over to VEB, to be used for state purposes. VEB then reallocates these funds for approved import transactions. Boris Federov, a consultant to the CPSU Central Committee Socioeconomic Department, estimated in mid-1990 that "ninety-five percent of the redistribution of currency proceeds is carried out through budgetary allocations using administrative methods."[18] Needless to say, VEB cannot do as efficient a job in allocating hard currency as a functioning currency market might. So difficult are the problems of retaining or disposing productively of hard-currency earnings that Soviet exporters have apparently resorted to a variety of complicated arrangements with foreigners to keep hard-currency earnings from ever getting back to the Soviet Union. Western bankers involved in Soviet trade finance report that Soviet exporting agencies sometimes seek to use export earnings to buy Western goods for import into the Soviet Union. The idea, apparently, is that the enterprise has a better chance of maintaining control of or selling Western goods than Western currencies.

Since the beginning of *perestroika*, there has been a debate both inside and outside the Soviet Union over whether and how to make the ruble more convertible. In November 1989, VEB took a first

[18]Boris Federov, "Economic Policy and Ruble Convertibility," *Kommunist*, June 1990, pp. 48–57. Translation available in FBIS-SOV-90-138-A, July 18, 1990, pp. 19–25.

halting step toward ruble convertibility by holding its first-ever auction of hard currencies for rubles. A second auction was held in January 1990.[19] Initially, only Soviet state enterprises were allowed to offer or to bid for currency in these auctions. The circle of authorized participants has expanded somewhat, and now includes collective farms, joint ventures, and cooperatives. The amounts transacted at these auctions have been quite small, however—only a bit over 8 million rubles at each of the two auctions, for example. Not surprisingly, successful bids represented a severe devaluation of the ruble—at the second auction, for example, successful bids for dollars were as much as 21 times higher than the official exchange rate. By early 1991, there were reports of auction prices of 35 rubles per dollar, more than 50 times the official exchange rate.[20]

In October 1990, Soviet President Gorbachev issued decrees affecting foreign direct investment in the Soviet Union and ruble convertibility.[21] Henceforth, foreigners would be allowed 100 percent ownership of enterprises operating in the Soviet Union. (They had previously been restricted to minority stakes.) The decrees also called for somewhat confusing changes in foreign exchange arrangements. The old system of foreign trade "coefficients"—effectively, a set of some 3000 different ruble exchange rates, each to be used for a particular kind of international transaction—was to be replaced by a new single "commercial" exchange rate. This new exchange rate was set initially at $0.60 per ruble, compared with a prevailing "official" exchange rate of $1.79 per ruble. The official rate was to be used in the future only for statistical purposes and for calculating the payments due to the Soviet Union from developing countries on ruble-denominated loans. The new commercial rate was to be used by all Soviet enterprises, by joint ventures, and by foreign enterprises operating in the Soviet Union.[22]

The new commercial exchange rate joined a "tourist" or "special" rate that had been introduced a year earlier. Effective November 1, 1989, foreign visitors to the Soviet Union were permitted to exchange hard-

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[19]Quentin Peel, "Soviet Hard Currency Auction Highlights Pressure on Rouble," *The Financial Times*, November 6, 1989; and "Forex Sale Marks Down the Rouble," *The Financial Times*, January 23, 1990.

[20]Leyla Boulton, "Moscow in Move to Establish Currency Market," *The Financial Times*, March 14, 1991.

[21]For the text of these decrees, see *Izvestiya*, October 27, 1990. Translations available in FBIS-SOV-90-209, October 29, 1990, pp. 69–70.

[22]Quentin Peel, "Foreign Business Puzzles over Soviet Investment Decree," *The Financial Times*, October 30, 1990.

currency cash for rubles at a rate that represented an effective 90 percent devaluation of the ruble. (At the time, the prevailing official rate was about $1.60 per ruble. The tourist rate was about 16 cents per ruble.) Soviet citizens wishing to obtain hard currency for a visit abroad were also forced to exchange rubles at the tourist rate. This measure had been aimed at discouraging black market exchange transactions by tourists. Perhaps not surprisingly, it was not entirely successful; at the time, the black market exchange rate was about 7 or 8 cents per ruble. The tourist rate was finally brought into line with prevailing black market rates in April 1991, when it was cut by more than three-quarters, to 3.6 cents per ruble.

Gorbachev's October 1990 decrees also specified that from January 1, 1991, hard currencies would be available to all economic entities—Soviet and foreign—at what the decree called a "market" exchange rate. This provision seems to have been implemented by extending to selected Soviet banks the right to buy and sell foreign currencies on behalf of their depositors.[23] Beginning in April 1991, these banks participated in special weekly foreign currency auctions. The volumes transacted in these auctions have remained small, and the resulting market rate has remained equal to the tourist rate.[24] Despite these first faltering steps toward developing a functioning foreign exchange market in the Soviet Union, it remains very difficult to convert rubles into hard currency. The fact that banks and tourists are willing to pay—in ruble terms—16 times the commercial rate for hard currencies is a clear indication that the amounts of hard currency available at the commercial rate are inadequate to meet demand. The small volumes transacted in the currency auctions for banks suggest that even at market rates for foreign currency demand exceeds supply. For most practical purposes, then, the ruble remains nonconvertible.

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[23]"Commercial Banks Gain Access to Foreign Currency," *Izvestiya,* November 27, 1990. Translation available in FBIS-SOV-90-232, December 3, 1990, pp. 59–60.

[24]Michael S. Lelyveld, "Soviets Seen Shying Away from Free Ruble Market," *Journal of Commerce and Commercial,* May 8, 1991.

WHY WAS THE LOSS OF SOVIET CREDITWORTHINESS SO RAPID?

The Soviet Union's fall from international financial grace was extraordinarily rapid. As we noted in Sec. 4, the Soviet Union raised money from international banks on very fine terms as late as September 1989. But by February 1990, Soviet debt was being sold at discount. In the second quarter of 1990, Western banks refused to roll over maturing Soviet credits, and total bank credit to the Soviet Union contracted sharply. By mid-1990, the Soviet Union was effectively shut out of international markets without guarantees from Western governments. When the end came, it came quite suddenly. The Soviet Union went from borrowing on the finest terms to borrowing not at all. There was no intervening period of growing market uneasiness during which the terms on which the Soviet Union could borrow became gradually harsher.

Such sudden swings in market sentiment are not unprecedented. Voluntary bank lending to a number of developing countries was suspended almost overnight during the various "debt crises" of the early 1980s.[25] (Indeed, this sudden loss of credit in some cases was an important contributor to the "crisis.") And, as was the case with the Soviet Union, a period of less favorable terms did not always presage the total suspension of lending. The fact that such swings in market sentiment have happened before, though, does not provide an explanation for why Western creditors lost faith in the Soviet Union so quickly and so completely. Could they not have foreseen the problems that the Soviet Union was facing?

Apparently, they did not. But this too is puzzling. It was widely understood from 1986 or 1987 on that the path to reforming the Soviet economy would be a difficult one and that total output of the Soviet economy would probably fall before it rose. Because *glasnost* preceded *perestroika*, considerable anecdotal if not systematic evidence was available on just how inefficient the Soviet economy was. In particular, it was widely recognized long before the beginning of 1990 that the Soviet oil industry was in trouble and that Soviet oil export revenues would likely be falling. Yet none of these factors seems to have deterred Western lenders through the end of 1989.[26]

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[25]In some cases, total bank lending continued to increase as banks "involuntarily" made new loans to allow debtors to stay current with interest payments on existing loans.

[26]Or at least through the fall of 1988. As we noted in Sec. 4, the appearance of national syndicates for lending to the Soviet Union during this period may have disguised some deterioration in the terms of lending to the Soviet Union.

It may be that risk assessments by Western lenders weighted political factors more heavily than economic factors. After years of doing without reliable or systematic information on Soviet economic circumstances, potential lenders might quite understandably have chosen to base lending decisions on the long track record of prompt payment compiled by Soviet central authorities and on the demonstrated ability of these authorities to allocate economic and financial resources to whatever purposes they thought appropriate. Also reassuring to potential lenders would have been the restraint shown during the early Gorbachev years with regard to foreign borrowing. It is not only cynics who have observed that bankers are most comfortable lending to people who do not need to borrow.

If these political considerations were in fact the basis for Western decisions to lend to the Soviet Union, the swift change in market sentiment is easier to understand. It was only at the beginning of 1989 that the new pattern of heavy foreign borrowing was established. Because of lags in data reporting, it was not until the fall of 1989 that this new pattern could be discerned in official statistics. (BIS reporting on international bank lending runs about six months behind the fact.) Thus, it was not until late in 1989 that it become clear that the stance of Soviet authorities with regard to foreign borrowing had changed.

Late in 1989, signs were also emerging that the central authorities were no longer fully committed to rapid economic reform. In August 1989, President Gorbachev created a working group to draft a plan for economic reform. The resulting "500 Day" plan was debated in the Supreme Soviet during September without, it appeared, Gorbachev's full support. A modified version of the plan prepared by Abel Aganbegian also failed to gain Gorbachev's approval, and in October 1989 Gorbachev produced his own plan: "Basic Directions of Stabilization of the National Economy and Transition to a Market Economy." Most reformers found the "Basic Directions" a disappointment, and many observers both inside and outside the Soviet Union saw it as an attempt to shore up the old system of central planning. More important, though, was the perception that Gorbachev had been forced into the "Basic Directions" plan by conservative elements opposed to economic reform. Thus, suspicion began to grow that Gorbachev was no longer fully in control of economic policy. It was also at about that time that republican leaders first openly challenged the authority of the central government. Suddenly, the principal basis for Western willingness to lend to the Soviet Union—faith in central authorities—was eroding. Unsure of who had the authority to make

and to keep commitments, potential lenders pulled back. If these lenders needed any confirmation that their caution was justified, it came early in 1990 when the first reports of Soviet payment arrearages began to circulate. Clearly, they were no longer dealing with the drab but reliable Soviet Union to which they had grown accustomed.

9. THE OUTLOOK FOR SOVIET INTERNATIONAL FINANCE

These are times of rapid change in the Soviet Union, politically and economically. Consequently, any forecast made now is in danger of appearing ridiculous in a few months' time. Nonetheless, the preceding sections of this report suggest a few key characteristics of the Soviet international financial situation that will likely persist into the medium-term future. By way of summary, this section notes and comments on these characteristics.

CONTINUED DEPENDENCE ON OFFICIAL AND OFFICIALLY GUARANTEED CREDIT

The most important characteristic of the current Soviet international financial situation is that the Soviet Union has virtually no access to international credit markets on normal commercial terms. For all practical purposes, the Soviet Union is able to raise hard-currency credits only from Western governments or from banks with Western government guarantees. (A few additional fully collateralized deals, similar to the arrangement with De Beers, may be possible, but Soviet commodities that could serve as collateral are limited—probably to gold and precious gems—and it seems unlikely that such deals will generate much of an inflow of funds.) Until relations between the Soviet central government and the union's constituent republics are clarified and until a significant program of economic reform is clearly on its way to success, it is hard to imagine how this situation can change appreciably. Today, potential lenders can have no confidence that the entities or the officials with whom they sign agreements will have any control over real commodities or hard-currency funds in the future. These matters will not be resolved soon, and it therefore seems unlikely that the Soviet Union will regain commercial access to Western credit markets for at least a few years.

Some—both inside and outside the Soviet Union—have hoped that the foreign capital necessary to finance a restructuring of the Soviet economy might come from foreign direct investment. Direct investment does not generate the debt-servicing burden that comes with borrowed funds, and direct investment might bring much needed access to technology and management techniques. Large inflows of

foreign direct investment also seem improbable, though—at least for the next several years. Without clear concepts of ownership, without a mechanism for repatriating profits, without a legal system to enforce contracts and resolve disputes, and most important without a clearly identified authority to whom a potential investor may turn to resolve the welter of conflicting laws, regulations, and decrees generated by contending union, republican, and municipal governments, there seems little prospect that the Soviet Union can attract significant amounts of foreign direct investment.

Thus, the Soviet Union will have to continue to rely heavily on official and officially guaranteed sources of credit for the next few years. The principal implication is that Soviet international finance is now and will likely remain closely tied to political circumstances—to a greater degree, perhaps, than it has been at any time since the end of the Second World War. The Soviet Union will be able to raise funds only with the concurrence of Western governments, and political developments—both inside and outside the Soviet Union—will strongly influence these governments' policies. Rather suddenly, a critical component of any long-term campaign to restructure the Soviet economy has become contingent on continued approval in Western capitals of how the Soviet Union is conducting its internal and external affairs. Already, for example, we saw in January 1991 the withdrawal of an offered $1 billion in aid from the European Communities as a result of the Soviet crackdown on the independently minded Baltic republics. The aid was subsequently restored, but no one can have missed the linkage of aid flows to internal Soviet policies.

THE NEED TO ROLL OVER MATURING CREDITS

Soviet dependency on the continued good will of Western governments is heightened by the short maturities of many existing Soviet credits. As of June 1990, $17 billion in Soviet debt to Western banks was scheduled to come due within the next twelve months. Some trade-related credits from both official and private sources will undoubtedly also come due during this period. Add to this a few billion dollars worth of already overdue payments for imports, and we arrive at a Soviet gross borrowing requirement of something like $20 billion dollars in a twelve-month period, *even if there is no net inflow of new credit to the Soviet Union.* At the end of 1990, Soviet hard-currency deposits in Western banks—which might be drawn down to repay maturing credits—amounted to about $8.7 billion. Not only

will the Soviet Union have to rely on assistance from Western governments—either in the the form of direct loans or guarantees for private loans—it will have to do so soon and repeatedly. The need to keep rolling over large amounts of short-term debt will keep Soviet financial circumstances hostage to political sentiment in the West on a week-to-week or month-to-month basis. Even a temporary interruption in the process of rolling over maturing credits has the potential for causing serious disruptions in Soviet international finance.

SOVIET FINANCING FOR OTHER COUNTRIES

The one (relatively) bright spot in the Soviet international financial outlook is that, until recently at least, there has been considerable slack in Soviet hard-currency accounts. As near as we can tell, the Soviet Union itself has been getting by with only a minimal net inflow of foreign capital. Indeed, until 1989 the Soviet economy itself appeared to be in a position to be a net supplier of hard-currency funds to the rest of the world. (See the discussion in Sec. 8 and the figures in Table 8.1.) Throughout the 1980s, the Soviet Union was raising more funds in international credit markets than it needed for its own internal purposes. Much of the excess appears to have been passed on in the form of unpaid-for goods and direct credits to various Soviet client states in the Third World. The CIA estimates that these flows exceeded $5 billion in 1988 and again in 1989.

No estimates are yet available for 1990, and it would not be surprising to see both that Soviet internal borrowing needs have continued to grow and that Soviet aid to other countries has been sharply curtailed. If it were willing to cut back significantly on its aid to client states the Soviet Union could reduce somewhat its imports of foreign capital—perhaps by a few billion dollars per year—without major direct consequences for the Soviet economy.[1] It is even possible—but given the very unsettled state of the Soviet economy, it is impossible to say this with any confidence—that the Soviet Union could survive a small net outflow of hard-currency funds. It appears that this would have been possible throughout most of the 1980s, and it might be possible again.

But even in this most optimistic—from the Soviet point of view—case, the Soviet Union will continue to face a difficult international

[1]As we noted in Sec. 8, estimates of the flow of Soviet aid to other countries may be somewhat inflated. Thus, the scope for potential Soviet belt-tightening may be somewhat less than these estimates initially suggest.

financial situation. Even if the Soviet Union can bring its net hard-currency borrowing needs to zero, it will still have to face the daunting task of raising something like $15 or $20 billion dollars per year in hard-currency funds just to refinance maturing credits. Given its currently restricted access to international credit markets, this will not be an easy matter. The alternative is for the Soviet Union to begin running large hard-currency current account surpluses. With the prospects dim for major increases in the value of Soviet exports, this would require reductions in Soviet imports, slower modernization of the Soviet industrial base, and more pain for the long-suffering Soviet consumer.

Appendix

Table A.1

Soviet Assets and Liabilities Vis-à-Vis BIS Reporting Banks (in billions of U.S. dollars)

Quarter		Levels			Changes, Adjusted for Exchange Rate Change		
		Assets	Liabilities	Net Debt	Assets	Liabilities	Net Debt
1984	I	12.851	17.501	4.650	1.692	0.971	–0.721
	II	11.499	16.263	4.764	–0.697	–0.644	0.053
	III	11.108	16.141	5.033	0.292	0.474	0.182
	IV	11.343	16.640	5.297	0.401	0.800	0.399
1985	I	8.779	16.036	7.257	–2.630	–0.751	1.879
	II	9.569	18.890	9.321	0.751	2.740	1.989
	III	11.106	21.172	10.066	1.109	1.027	–0.082
	IV	13.062	22.726	9.664	1.698	0.702	–0.996
1986	I	12.567	23.216	10.649	–0.807	–0.286	0.521
	II	13.426	26.197	12.771	0.620	2.322	1.702
	III	13.759	28.324	14.565	0.055	1.182	1.127
	IV	14.840	29.077	14.237	0.973	0.403	–0.570
1987	I	13.174	28.921	15.747	–2.016	–1.388	0.628
	II	12.656	29.998	17.342	–0.470	1.309	1.779
	III	13.561	31.457	17.896	0.905	1.481	0.576
	IV	14.135	33.343	19.208	–0.360	–1.135	–0.775
1988	I	14.447	34.531	20.084	0.564	2.025	1.461
	II	14.155	34.006	19.851	0.220	1.233	1.013
	III	13.832	33.137	19.305	–0.175	–0.301	–0.126
	IV	15.311	36.853	21.542	1.149	2.614	1.465
1989	I	14.657	38.866	24.209	–0.285	3.292	3.577
	II	15.314	39.869	24.555	0.867	1.781	0.914
	III	15.228	42.455	27.227	–0.314	1.678	1.992
	IV	14.676	44.832	30.156	–0.954	0.705	1.659
1990	I	12.170	45.270	33.100	–2.518	0.391	2.909
	II	8.644	41.279	32.635	–3.615	–4.631	–1.016
	III	7.796	43.057	35.261	–1.080	0.004	1.084
	IV	8.676	42.143	33.467	0.689	–1.922	–2.611

SOURCE: Bank for International Settlements.